FULL COLOUR THINKING

GRADUATE SCHOOL OF BUSINESS
UNIVERSITY OF CAPE TOWN

Bound to Impact: a best practices guide to term sheets in African Impact Investing deals

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by

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PLAGIARISM DECLARATION

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ABSTRACT

This study focuses on the Impact Investing industry in sub-Saharan Africa through a comparative analysis of three industry-leading institutions' term sheets. A key output of this exploratory research is the development of a best practices guide to social and environmental covenants (clauses included in the term sheet). The researcher has compiled primary data through practitioner interviews; secondary data was compiled by analysing executed legal documents and templates. The process was conducted with academic rigour in order to categorise and compare specific information.

Preliminary research involved the researcher exchanging with a DFI and two commercial Impact Investors. The DFI provides both equity and debt, whereas one of the commercial Investors specialises in private equity and the other in private debt. The institutions are industry agnostic.

The study has the objective to test two linked null hypotheses:

- Impact Investors do not align their terms sheets to their values; and
- Impact Investors do not require that certain clauses be systematically included in order to protect their interests

Through case studies, the research initially develops on the key elements of an equity term sheet and provides a fictitious debt term sheet as a reference. Equity and debt legal documents are compared and analysed independently.

After having isolated and analysed social & environmental covenants, the researcher concludes that neither hypothesis can be rejected.

Further research is recommended limiting the scope to a specific industry or a specific asset class. Understanding and comparing Development Finance Institutions' methods would be of value. A quantitative analysis would isolate the success factors and appropriate constraints on the legal documentation in order to maximise financial and social & environmental returns.

Keywords: Impact investing, sub-Saharan Africa, term sheet, S&E covenants, private equity, private debt, best practices, social finance

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GLOSSARY OF TERMS

AUM	Assets Under Management
b	Billion
BF	Bamboo Finance
BFIF	Bamboo Financial Inclusion Fund
BFOF	Bamboo Finance Oasis Fund
BO	Blue Orchard
BOMF	Blue Orchard Microfinance Fund
CDC	CDC Group
CIF	Blue Orchard Climate Insurance Fund
DD	Due Diligence
ESG	Environmental, Social and Governance
GBP	Great Britain Pounds
GDP	Gross Domestic Product
GIIN	Global Impact Investing Network
GP	General Partners
IRR	Internal Rate of Return, a widespread metric to calculate an investments performance.
KYC	Know Your Customer
LCY	Local Currency
LP	Limited Partners
m	Million
MEF	Blue Orchard Microfinance Enhancement Fund
MFI	Micro Finance Institution
MIFA	Blue Orchard Microfinance Initiative for Asia
PaR	Portfolio at Risk
PD	Private Debt
PE	Private Equity
PPP	Public Private Partnerships
REFFA	Blue Orchard Regional Education Finance Fund for SSA
S&E	Social & Environmental
SPIRIT	Social Performance Impact Reporting & Intelligence Tool
SPTF	Social Performance Task Force
SSA	sub-Saharan Africa
TS	Term Sheet
UNPRI	United Nations Principles for Responsible Investments
USD	US Dollars
WEF	World Economic Forum

1. INTRODUCTION

1.1. Background

Economic development and economic growth; these two concepts have highly impacted the public and the private sector. While the latter can be seen as the consequence of the former, it is merely an indicator. Economic growth quantitatively measures the value of goods and services over time. It is a hard indicator, a number. It can be monitored periodically and reflect growth, can compare different economies in a systematic way, can justify capital flows from foreign countries and it sizes the impact of policies. However, it neglects the complex and interlinked qualitative effects. The qualitative implications are the focus of economic development, that studies the standard of living and economic health of a certain area.

> *"More than half the people of the world are living in conditions approaching misery. Their food is inadequate, they are victims of disease. Their economic life is primitive and stagnant. Their poverty is a handicap and a threat both to them and to more prosperous areas. For the first time in history humanity possesses the knowledge and the skill to relieve the suffering of these people."*
>
> *President Harry Truman, 1949*

This citation is from Harry Truman, the president of the United-States of America at the initiation speech of the post war reconstruction. His words reflect the developmental state of a world after destruction, and the objective to help to rebuild it.

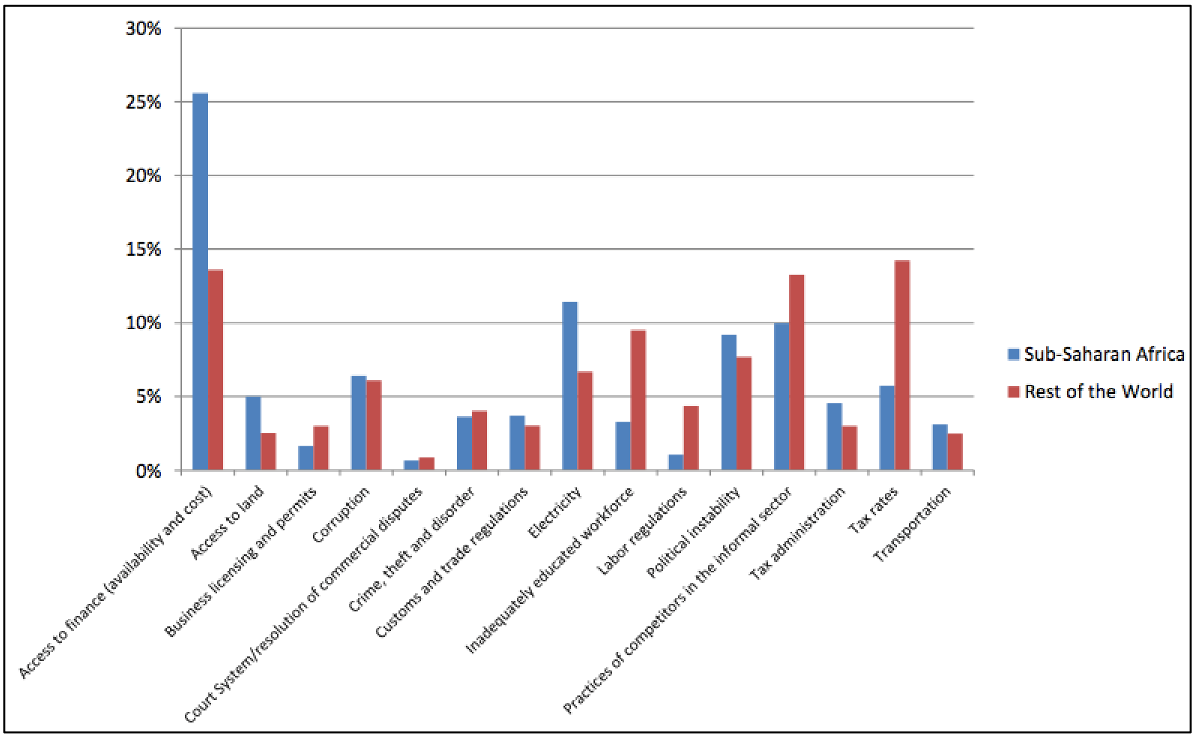
Over half a century later, his observations are still valid, particularly in sub-Saharan Africa ("SSA"). 46.8% of SSA's population lives under the poverty line[1] (World Bank, 2011). Only 24% of the population of SSA has access to electricity (World Bank, 2013). In 2011 there were an estimated 23.5 million people living with HIV in SSA (UNAIDS, 2012). These are only a few challenges that SSA faces that have a severe impact on growth and development in the long term. Having briefly reviewed the challenges, the focus of this paper will now be placed on opportunities.

[1] Poverty headcount ratio at $1.25 a day (PPP)

Entrepreneurship is an important contributor to economic development. New firms tend to be more efficient, therefore putting pressure on incumbents, increasing competition and increasing economic growth (Klapper et al., 2006). Many studies, both theoretical and empirical, have demonstrated that new firm creation has a positive effect on growth and development (Black & Strahan, 2002). SSA has the lowest rate of new firm creation in the world. On average, 55'000 newly registered limited-liability firms are opened per year in industrialised countries, relative to about 35'000 in Latin America, 14'000 in South Asia, and 9'000 in SSA (Klapper & Love, 2010).

Especially in developing countries, limited access to finance (such as equity, guarantees, credit, as well as deposits and payments facilities, to list a few) remains one of the main obstacles to emerging entrepreneurs (Ayyagari, Demirguc-kunt, & Maksimovic, 2012). First, the availability of finance is positively associated with the number of start-ups, firm dynamism and innovation (Aghion, Fally, & Scarpetta, 2007). Second, finance allows existing firms to grow, exploit possible investment opportunities and to achieve a larger equilibrium size (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2007). Finally, firms are able to choose more efficient organizational forms such as incorporation and can safely acquire a more efficient productive asset portfolio where the infrastructure of finance is in place (e.g., Demirgüç-Kunt, Love and Maksimovic, 2006). Entrepreneurs of all types and sizes require a variety of financial services, including facilities for making deposits and payments as well as accessing credit, equity and guarantees. The following figure shows the most important growth obstacles as noted by firms in countries in SSA and outside of SSA.

Figure 1: Obstacles to firms' operation and growth in international comparison



Source: Beck & Cull, 2014

Although there are many sources of financing for emerging enterprises, this document will focus on Impact Investing. In line with Harry Truman's ideals, Impact Investing has the potential to tackle some of SSA's key challenges and development goals.

Impact Investing[2] is an emerging investment strategy that has the dual aim of generating financial returns alongside positive social and environmental ("S&E") impact ("Impact"). It invests in companies, funds and organizations that have an inclusive business model. The investments occur across asset classes, mainly including private equity and venture capital ("PE") as well as private debt ("PD"). It is important to note that the definition of the industry remains ambiguous. This paper will use the Impact Investing characteristics, as defined by the GIIN. In order to be considered an Impact Investor, the fund manager is required to take into account the following four "pillars". First, the Investor is required to have an underlying intentionality to generate positive S&E returns. De facto, investments made in emerging markets have an Impact (capital inflow, job creation, increased GDP, etc.), but are not defined as Impact Investments without the underlying intention. Second, there is a financial

[2] The term "Impact Investing" was coined in 2007 in an initiative led by the Rockefeller Foundation, giving a name to various social investment methodologies that had been tried for decades.

return expectation. The fund should at least redistribute the investors' initial capital commitments at the end of the contracted investment period. Third, Impact Investments are defined within a range of asset classes constituted of an instrument (equity, debt, guarantees or a mix) and a return range (below, above or average market rates). Finally, the Investor takes an active approach in measuring the Impact through predetermined metrics (GIIN, 2010).

Table 1: The 4 "pillars" of Impact Investing

Impact Investing pillars	Definition
1. Intentionality	Intention to generate positive S&E Impact
2. Financial returns	At minimum return the invested capital to investors
3. Defined asset class and range of return	Define the asset class (equity, debt, mezzanine) and range of returns (below, above or market rate)
4. Active measurement	Active approach to Impact measurement through predefined metrics

Source: Author

The sectors in which Impact Investing typically allocates capital can be divided into four main categories: access to basic products and services (such as financial services, healthcare and education), infrastructure development (such as housing, energy and water), social development (job creation, entrepreneurship, gender equality) and environmental challenges (usually solutions to reducing waste and pollution). These sectors are particularly relevant to the African Union Agenda 2063 goals of the Pan African vision of "an integrated, prosperous and peaceful Africa, driven by its own citizens and representing a dynamic force in the global arena." (Agenda 2063, 2014). The report highlights a number of sectors relevant to Impact Investing (healthcare, poverty eradication, education and financial services, to name a few).

A recent study has created a benchmark of Impact Investments' financial performance globally. Emerging markets Impact Investment funds have returned 9.1% to investors versus 4.8% for comparable funds[3]. Those focused on Africa have performed particularly well, returning 9.7% to investors (Matthews, Sternlicht, Bouri, Mudaliar, & Schiff, 2015). These numbers are not only encouraging for investors in the sector, but will allow fund managers to benchmark their performance to the industry average.

[3] Performance is measured as an average of the internal rates of returns (IRR) of the sample companies

Looking more specifically at the Impact Investing deal cycle (deal sourcing and screening, investment analysis and valuation, due diligence ("DD") and investment structuring, term sheet and documentation, capital disbursement, value generation and finally exit), the term sheet ("TS") and documentation phase is a particularly delicate process. During this negotiation, the Investor and investee lay out the key elements of the deal. The TS is a document that covers the investment structure, preferences, and specific rights. Impact Investors could include particular clauses that relate to the S&E mission which gives the Investor a certain amount of flexibility in case there is a compromise made by the investee. Once the TS is agreed upon, the Investor and the investee bear a common contractual bond. They are bound to Impact.

1.2. Problem statement

Despite the admirable goals of Impact Investing - generating positive Impact alongside financial returns - the sector faces a number of key challenges.

Table 2: Challenges to the growth of the Impact Investing industry today

N = 146; respondents ranked top three

Rank	Score	Available answer choice
1	193	Lack of appropriate capital across the risk/ return spectrum
2	174	Shortage of high quality investment opportunities with track record
3	115	Difficulty exiting investments
4	97	Lack of common way to talk about Impact Investing
5	87	Lack of innovative deal/ fund structures to accommodate investors' or portfolio companies' needs
6	76	Lack of research and data on products and performance
7	67	Inadequate Impact measurement practice
8	57	Lack of investment professionals with relevant skill sets

Source: GIIN, J.P.Morgan

First, it is important to highlight the high demand and traction that the Impact Investing industry is gaining. The Global Impact Investing Network (GIIN) estimates the total assets under management (AUM) to be approximately USD 60b (Saltuk, Idrissi, Bouri, Mudaliar, & Schiff, 2015). The consequence of this is that many PE fund managers in developing countries, more specifically SSA, market themselves as Impact Investors in order to attract capital commitments. Investments with Impact are not necessarily Impact Investments. Due to the regional context, any investment made on the African continent will have some level of Impact, especially related to job creation and enhanced efficiency. However, if there is not the intentionality and the monitoring, it should not be considered as an Impact Investment *per se*. In this regard, and due to the lack of homogeneity in the industry, certain fund managers are exploiting these financial resources, resulting in capital misplacements.

Second, fund managers find themselves faced with difficulties in placing capital using traditional investment structures. A recent study indicates that "Lack of innovative deal/fund structures to accommodate Investors' or portfolio companies' needs" is the fifth biggest challenge to the growth of the Impact Investing industry (Saltuk et al., 2015). In particular, the deals are structured as regular PE transactions. Unfortunately, the structure of the deal does not systematically account for S&E Impact. This is an issue for both the portfolio companies that are pursuing a specific S&E mission and for the fund managers who want to align the structure with their values. The issue remains valid independent of the Investors' organization type (development finance institution, fund manager, bank, foundation, etc.), as well as for the asset class.

Third, a large portion of primary investors (the limited partners), especially high net worth individuals (HNWI), invest their personal capital into Impact Investing funds based on their values. Despite being aware of a specific investment strategy, there is no guarantee that the funds invested will be directed towards companies that reach a certain Impact threshold, or, at the minimum, share the LP's values. The third challenge causes two problems. The first one is ethical, where the fund manager is not fulfilling his mandate and therefore is misleading the investor. The second is that the capital is misplaced, where capital designated to invest in specific types of entities is shifted to others. This misplacement causes discrepancies in the market, as entities fitting the Impact Investment mandate, which are usually not eligible for more traditional sources of financing, remain subject to acute financing shortages.

Finally, Impact Investors face the difficulties of enforcing the Impact requirements on the investees. Once the capital is disbursed, the Investor has limited or no control over the investee company, depending on the financial instrument (for example, debt) and deal structure (for example, taking a minority stake). These requirements vary depending on the investment, but usually relate to Impact reporting, attaining specific Impact milestones, conditions to capital disbursement, use of funds, etc. Certain tools, in this case covenants, are put into place to enforce sanctions in case the portfolio company fails to attain certain agreed upon targets.

While these challenges are all unique, they would benefit from appropriately designed contractual agreements. Impact Investing has inherited industry standard financial covenants that are in use in the TSs. There is, however, limited homogeneity relating to S&E covenants and innovative deal structuring. This research intends to focus on the latter in order to compile industry best practices.

1.3. Objectives of the study

This study intends to analyse if and how Impact Investors are including S&E covenants within their deal TSs. The study intends to create a comprehensive document that introduces the traditional methods for TS drafting, helps to understand its complexities, develops an argument on how it can be used as a tool for S&E Impact and aggregates unique insight into industry leading best practices.

The study intends to inform, among others, LP, fund managers, academia and organisations seeking to raise capital from Impact Investors. The first category, LP, should be able to have an in depth understanding on how the capital is disbursed, how the fund manager is protecting his interests and values and lastly how his capital is working to create the Impact that he intends. Second, fund managers could benefit from obtaining a unique insight into how leading Impact Investors are structuring their deals. Third, academia should benefit from an in depth understanding of how practitioners approach and execute their deals. In addition, it will allow students to obtain insight into the Impact Investing industry and understand the mechanics behind deal making. As an exploratory project, the study intends to find additional areas of research that should result in follow-on studies. Finally, this document will be of use to organisations planning to raise capital by clarifying key issues relating to the TS, allowing fund raisers to benchmark their offers to industry best practices.

1.4. Research questions and scope

The research questions can be broken down into two linked hypotheses.

Hypothesis 1 (null): Impact Investors do not align their TSs to their values.

The first hypothesis will test whether or not Impact Investors have an alignment between their values and what is included in their TSs. The reason why this is an important research question is due to the fact that most Impact Investors take a public stance and market their values as a unique selling proposition to LP. The researcher states, *ex ante*, that the Impact

Investor should have systematic alignment between the values, the public statement and the requirements from the portfolio companies. The validity of this statement and its relevance will be tested throughout the research.

Hypothesis 2 (null): Impact Investors do not require that certain clauses be systematically included in order to protect their interests.

The second hypothesis looks further into the alignment of the Impact Investor with his values, testing whether certain clauses (or covenants) are systematically included in all investments. This uniformity would identify investment patterns that allow value consistency between each investment within the Impact Investor's portfolio. The relevance and accuracy of the hypothesis will be tested throughout the research.

1.5. Research relevance

As the Impact Investing industry is still growing, there is limited documentation and research focussing specifically on the sector. Furthermore, most studies and literature are reports by practitioners, not academia. To date, there is one book, Impact Investment (Allman and Escobar De Nogales, 2015), that is a practical guide to the investment process and S&E Impact analysis. One chapter is dedicated to TSs. However, it is based purely on a practitioner’s experience and does not aggregate information from multiple fund managers. To the researcher's knowledge, there is currently no literature dedicated exclusively to the TS process in Impact Investing.

The researcher is working with both the Faculty of Commerce of the University of Cape Town (UCT)'s Graduate School of Business and the Bertha Centre for Social Innovation, the first academic centre in SSA dedicated to advancing social innovation and entrepreneurship. This is relevant to the thesis' scope, as Impact Investing is at the crossroads of development finance, social innovation and mainstream finance. The interviewees will be exclusively industry practitioners. The information will be compiled and analysed with academic rigour.

As mentioned previously, this document does not exclusively target academia. The document intends to be accessible to a broader audience, including new and experienced practitioners, organisations planning to raise capital, students and LP.

1.6. Limitations

The study intends to focus on the best practices linked to TS drafting, negotiating, executing and enforcing. As such, it does not tend to prove or disprove the success of Impact Investments from both the financial and S&E perspective. In addition, the researcher intends to remain neutral regarding his opinions on the industry.

The study focuses on Impact Investors who have committed capital into businesses that operate in SSA. However, due to the scarcity of information, the researcher also studied TSs directed to alternate geographies when the information was judged relevant and added value. In addition, the fund managers had to publicly market themselves as Impact Investors in order to be part of the study's scope.

Due to the qualitative nature of the study, it is not exhaustive and intends to open follow-on opportunities for further research.

In addition, the researcher acknowledges that there is bias in the sampling method. The participating fund managers have been identified through the researcher's professional and personal network. However, due to the particularity of the private markets industry and the scarcity of the required information, the researcher believes that this is the best current approach to inductively build knowledge in the Impact Investing industry.

1.7. Assumptions

Assumptions will be made with regard to the accuracy of the details given by the interviewees, and that their responses will be truthful. To mitigate potential for inconsistencies, multiple participants have been identified, both in terms of fund managers and employees within each firm. This is to ensure that multiple perspectives of the process and methodology will be identified.

Considerable value can be added to the research by aggregating best-practices. These are based on the researcher's analysis and will attempt to be as impartial and exhaustive as possible. Assumptions will be made to this end, the details of which will be explored at the relevant stage.

1.8. Ethics

The research illustrates and analyses confidential information. All fund managers were approached in a consistent and systematic way. First, an introduction was conducted via email or telephone, explaining the scope of the research. After prior consent, a non-disclosure agreement ("NDA") was signed between the researcher and the fund manager. As a result, all relevant documentation was provided and interviews were conducted in a transparent manner. The information relating to the interviewees themselves is publicly available. All confidential matters, specifically relating to actual investments and strategies were anonymised or excluded from this document.

The interviewees were given the option to review a transcript of their interview and had the final word on the publication rights of this document. Prior to the final submission, each fund manager has independently read and given their consent relating to the disclosed information.

Any resemblance in this research with actual companies is unintended and should be interpreted as a coincidence.

1.9. Outline of the study

The study is divided in eight sections. After having introduced the study in section 1 (current section), the researcher will review relevant existing literature in section 2. Section 3 details the research methodology. Section 4 aggregates and analyses the research, and intends to extract relevant examples of best practices in Impact Investing TS drafting. Finally, section 5 will conclude with the key findings. As follow-on, the researcher will suggest recommendations for future study in section 6. Section 7 includes presents the references used throughout the study and section 8 includes appendices in support of the research.

2. LITERATURE REVIEW

2.1. Impact Investing

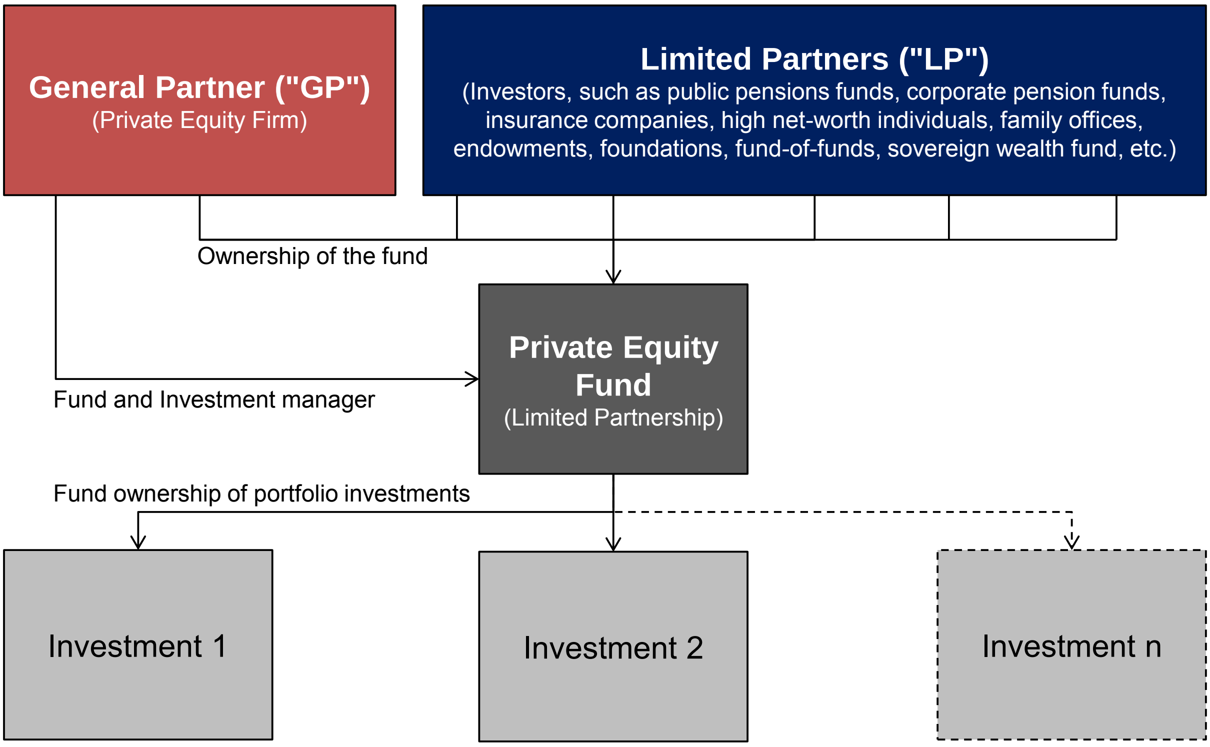
2.1.1. An investment strategy

There has been much debate regarding whether Impact Investing can be defined as an asset class. On one hand, some consider it to be an investment strategy. In this sense, Impact Investing is a criterion by which investments are made; therefore it is not an asset class. The World Economic Forum ("WEF") supports this opinion, and notes that an asset class is "traditionally defined as securities or investments that behave similarly under varying market conditions and that are governed by a similar set of rules and regulations" (World Economic Forum, 2013, p. 7). The author believes that Impact Investing is a "lens" through which investments are made. On the other hand, organisations such as J.P. Morgan, The Rockefeller Foundation and the GIIN define Impact Investing as an asset class. In the 2010 report entitled "Impact Investments - An emerging asset class" (GIIN, 2010) these three institutions define modern asset classes to have characteristics such as demand for professionals with a unique set of investment and/or risk management skills, structures on the buy-side that are organised around these professionals and allocate capital to them, industry organisations and networks dedicated to the asset class and an industry-wide effort to standardise performance and risk measurement (GIIN, 2010, p. 9). Despite the validity of both opinions, this paper supports the idea that Impact Investing is not an asset class on its own, but an investment strategy leveraging different asset classes to generate financial and positive S&E returns.

2.1.2. PE fund structure

In order to avoid confusion and maintain consistent wording across the study, it is important to understand the basic structure of a PE Fund (which is also applicable to other private instrument funds). The structure is highlighted in Figure 2. The General Partner ("GP") is the PE Firm. It is responsible for the fund. The Limited Partners ("LP") are the investors in the fund. The investors can be public pensions funds, corporate pension funds, insurance companies, high net-worth individuals, family offices, endowments, foundations, fund-of-funds, sovereign wealth fund, etc. The LP provide the vast majority of the funding. The GP has a mandate to manage and invest the funds. The PE Fund (Limited Partnership) will generally own an equity investment stake in the portfolio companies, also referred to as investees. At the end of the investment cycle, the fund will be dissolved and the LP recuperates the capital incremented by the returns. Remuneration is an important part of the research, and will be discussed further in the study. This structure applies to Impact Investing.

Figure 2: PE fund structure



Source: Author

2.1.3. Defining the industry

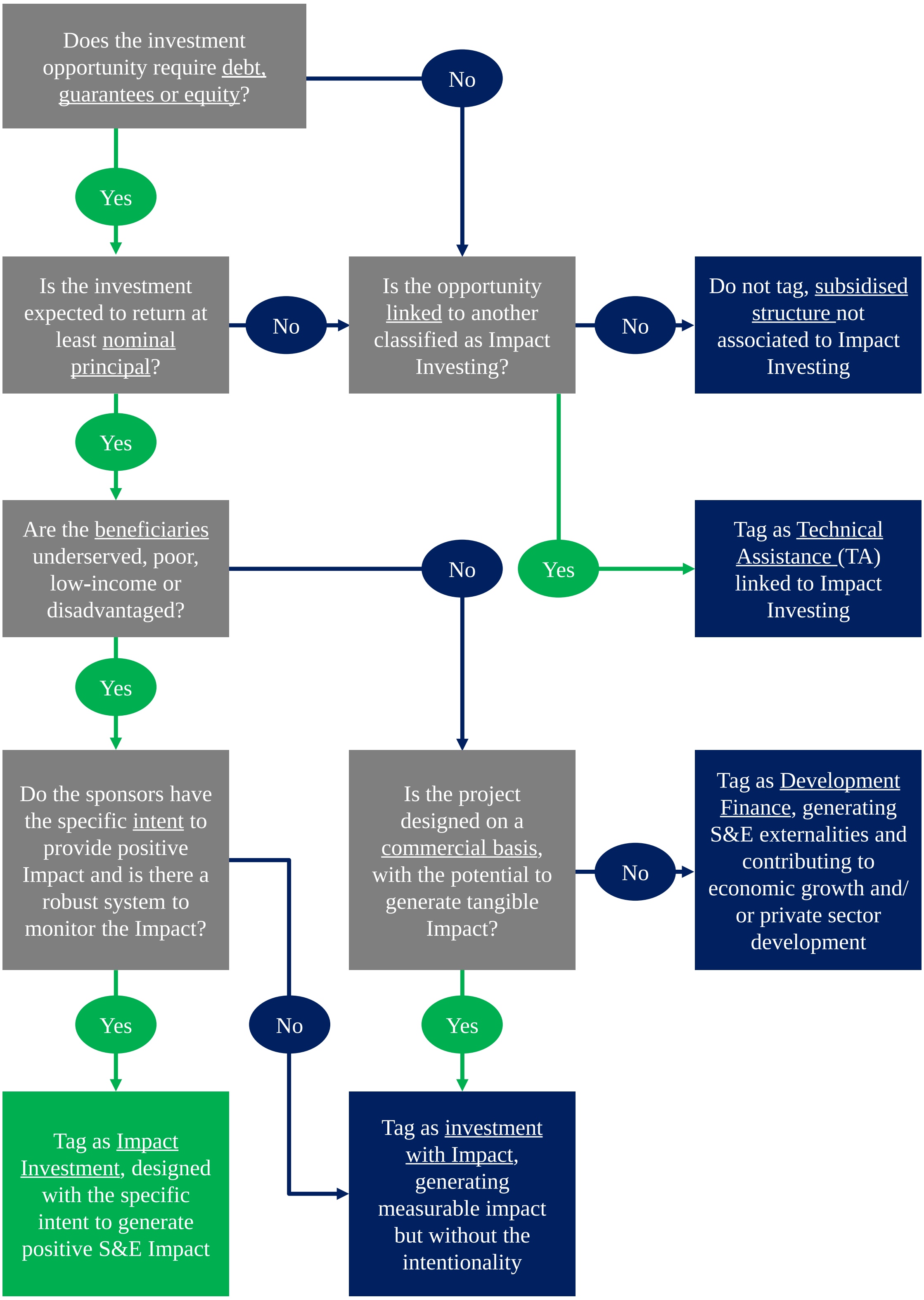
Before going into further detail, it is important to see how the definition of Impact Investing has evolved over time. The Monitor Institute (2009) defines Impact Investing as "actively placing capital in businesses and funds that generate social and/or environmental good and at least return nominal principal to the investor". The WEF (2013) gives a more thorough definition, including the notion of measuring Impact: "Impact Investing is an investment approach that intentionally seeks to create both financial return and positive S&E Impact that is actively measured". The GIIN notes that "Impact Investments are investments made into companies, organizations, and funds with the intention to generate S&E Impact alongside a financial return". The GIIN completes the definition with four core characteristics: intentionality, investment with return expectations, range of return expectations and asset class, and finally Impact measurement. This definition will serve as the structure for the literature review, as the researcher believes that it is the most holistic.

In order to avoid confusion, it is important to distinguish Impact Investing from responsible and sustainable investing. Responsible investing is a broader array of types of investments, which notably include Impact and sustainable investing. In terms of S&E practices, responsible investing mainly screens out target investments that have a negative S&E footprint (negative screening). The United Nations Principles for Responsible Investments ("UNPRI") articulate that this investment type “recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems" (UNPRI, 2013, p. 7). Sustainable investing distinguishes itself by actively incorporating Environmental, Social and Governance ("ESG") factors into investment decisions. However, it prioritises financial returns. The main method used is positive screening. Positive screening is a selective approach where the Investor will compare and select the investments based on specific criteria (for example, job creation, financial inclusion, gender equality, to name a few).

2.1.3.1. Intentionality

The most important characteristic of Impact Investing is the intent to generate S&E Impact. The capital provided must target a company or a fund that explicitly specifies the ESG goals. For instance, many Impact Investments target business models that provide goods and services to underserved populations (GIIN, 2010, p. 14). Among others, these companies are typically active in microfinance, financial services, agriculture, energy, healthcare, affordable housing and Education. Investors, especially those who focus on developing countries, would argue that all investments have an Impact. However, if there is no intentionality, then the investment is not by definition an Impact Investment. The notion of intentionality is becoming more and more important as the demand for Impact Investing increases: a number of mainstream PE investors are labelling themselves as Impact Investors, even when their actual Impact in negligible or at least unintended (Burckart, 2015). This effect is “a bit like adding ".com" to your name in 1999" (Salamon, 2014). Figure 3 gives a good overview of how the Impact Investing tagging process is performed.

Figure 3: Impact Investment tagging process



Source: Saltuk et al., 2015; Researcher

2.1.3.2. Investment with return expectations

In addition to S&E returns, Impact Investing aims to at least return the initial capital to LP (GIIN, 2010). This distinction is important to avoid confusion between Impact Investing and philanthropy, where the latter disburses capital in the form of charitable donations. The term philanthropy is used to cover virtually any kind of charitable activity that has some definable theme, goal, approach, or focus (Porter & Kramer, 2002).

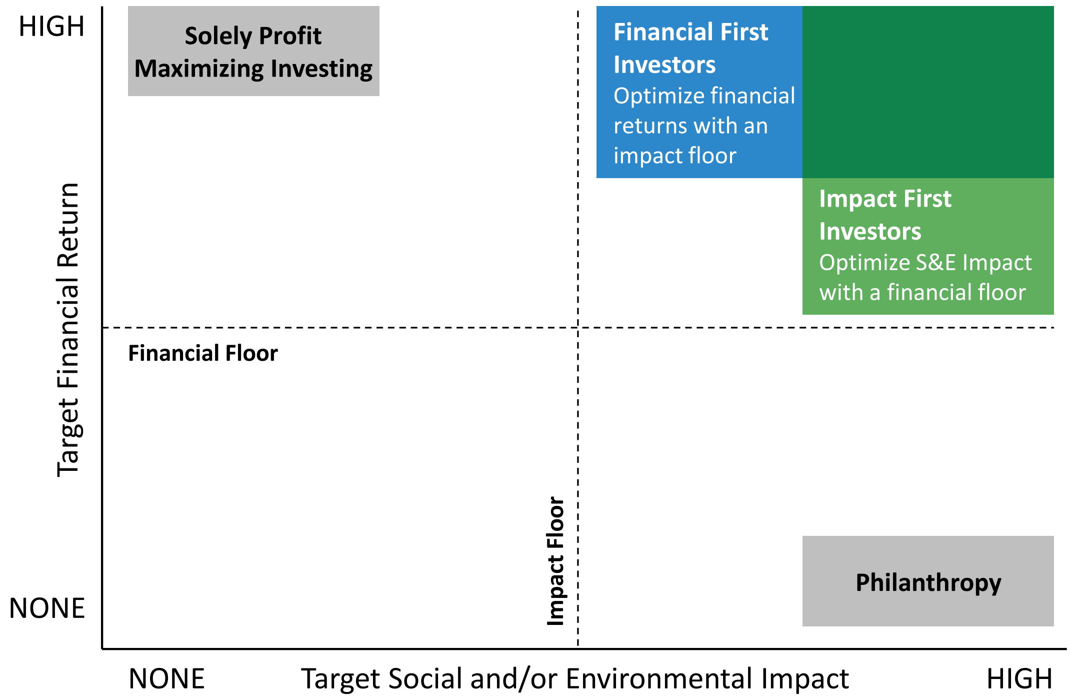
2.1.3.3. Range of return expectations and asset class

In addition to returning the initial capital to investors, Impact Investors offer returns that range from below market rates (often referred to as concessions) to risk-adjusted market rates (O'Donohoe, Leijonhufvud, Saltuk, Bugg-levine, & Brandenburg, 2010). Numerous theoretical views on the link between financial and S&E performance are put forward (for an overview, see Makni, Francoeur, & Bellavance, 2008). Many empirical studies investigate the relationship between S&E and financial performance (see Orlitzky, Schmidt, & Rynes, 2000). It is no surprise that there are different opinions about the interaction between financial and S&E performance and the empirical research has not arrived at a consensus. Opposing views have emerged. First, the liberal view suggests that there is a negative link, since investing in companies based on ESG criteria involves costs and is therefore a burden for competitiveness (Friedman, 1970). On the other hand, the stakeholder view affirms that satisfying stakeholders' interests will result in an improvement of the firm's financial and economic performance (Freeman, 1984; Porter & Linde, 1995). The neutral view suggests that stakeholder's invest in ESG issues in order to satisfy the stakeholder's demand, and that market forces will cancel out the positive and negative effects on financial performance (McWilliams and Siegel, 2001). Finally, there is a view that the link is complex, and can even result in a U-Shaped relationship between the two (Barnett & Salomon, 2002).

The paper by Margolis and Walsh (2001) is a good overview of numerous empirical studies regarding the relationship between S&E and financial performance, which will be used as the main reference to assess the existing literature on the matter. The key finding is that corporate social performance is treated as an independent variable in the majority of studies. This variable is used to predict or precede financial performance. Out of all the studied papers, approximately 50% found a positive relationship between the two, 25% found no relationship, 20% found mixed results and 5% found a negative relationship.

The Monitor Institute has an interesting way of categorising Impact Investors, by segmenting them into the "Impact first" and "financial first" category. The former seeks to maximise S&E value creation with a floor for financial returns. The latter seeks to optimise financial returns with a floor for S&E Impact (Monitor Institute, 2009, p. 32). Figure 4 illustrates these categories.

Figure 4: Segments of Impact Investors

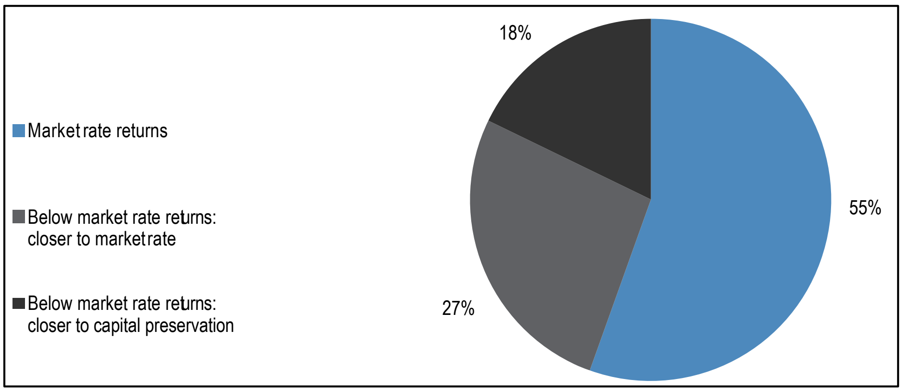


Source : Monitor Institute, 2009

This distinction is relevant to the range of return expectations. A recent report produced by the GIIN and JPMorgan shows that 55% of the sampled fund managers seek competitive returns, 27% seek below market rate returns that are close to the market rate and 18% seek to preserve capital. There is a recurring belief that Impact Investing is flawed, as there is a trade-off between S&E Impact and financial returns. Cambridge Associates and the GIIN collaborated to launch the Impact Investing Benchmark, the first comprehensive analysis of the financial performance of market rate PE Impact Investing funds. The result is encouraging: in aggregate, Impact Investment funds launched between 1998 and 2004 have outperformed funds in a comparative universe. Over the entire period analysed, Impact Investments returned on average 6.9%, compared to 8.1% in private investment funds. However, despite the average being lower, certain types of investments outperformed the comparative universe: Impact Investment funds that raised under $100 million returned a net

IRR of 9.5% to investors, compared to 4.5% in the comparative sample. Emerging market Impact Investing funds returned 9.1% to investors versus 4.8% (Matthews et al., 2015).

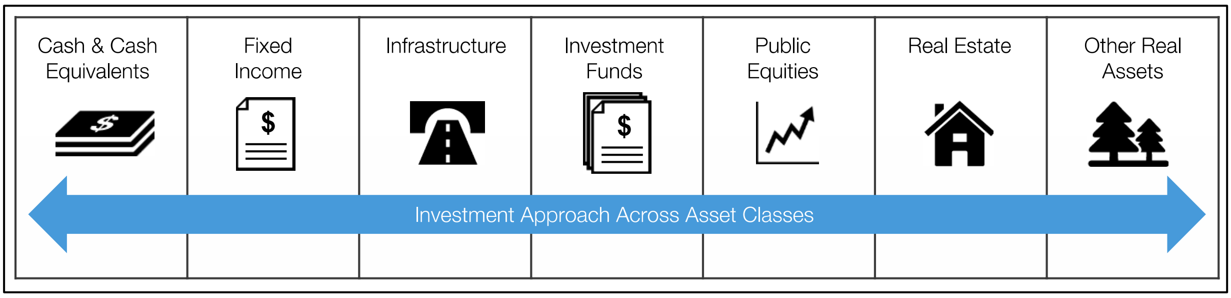
Figure 5: Target financial returns principally sought



Source: GIIN, J.P.Morgan

The results exposed on the range of returns shows how different strategies affect the risk/return profiles of investments. Many other asset classes offer opportunities for Impact Investing, as illustrated in Figure 66.

Figure 6: Impact Investing instruments



Source: WEF

However, the financial instrument that is used is debt, equity, or a hybrid form such as mezzanine debt or quasi-equity. One of the fundamental strategies to consider is the financial instrument. Based on their sample, the GIIN indicates that PD and PE are the most prominent instruments, accounting for 40% and 33% of assets under management, respectively (Saltuk et al, 2015). The notion of Impact Investing originated in PE, which is considered to be the most effective tool for systematic measurement of S&E Impact (World Economic Forum, 2013, p. 19). The researcher assumes that the reason for this is that an equity investor has an active role within the portfolio company and has the power to influence and change governance. This results in more control over S&E monitoring, measuring and reporting. In addition, PE generally outperforms debt in terms of returns, adds more value to the investments and is an appropriate tool for early stage as well as growth stage investments. Unfortunately, PE is usually considered a more expensive financial instrument as it is more resource intensive. The main disadvantage of PE is its heavy reliance on successful exits. Difficulty exiting investments is the third biggest challenge in Impact Investing (Saltuk et al, 2015). Finally, PE investments are considered highly illiquid and lock up investors' capital for a significant amount of time. Debt, on the other hand, offers a number of advantages for Impact Investing. Given the pressure to find liquidity, GPs may face trade-offs between maximising financial returns and ensuring the preservation of portfolio companies' missions. This raises the question whether GPs will sacrifice mission in exchange for financial returns (Gray, Ashburn, Douglas, & Jeffers, 2015).

In contrast, debt is first of all less resource intensive and can rely on a more standardised approach to investing. Indeed, loan agreements are usually highly consistent from one investment to another. This financial instrument also offers more liquidity, which is both advantageous for the fund managers and the LP. The major disadvantage of debt is that it limits the influence and control of the fund manager over the portfolio company. Most of the Impact and/or value-add has to be foreseen prior to the investment, and limits the potential flexibility. The key advantages of each financial instrument are highlighted in Table 3.

Table 3: Equity and debt comparative table

Debt	Equity
• Liquid • Shorter holding period • Consistent investment process • Less risky • Less resource intensive	• Higher financial returns • Control (governance) • Value-add during the holding period

Source: Researcher

2.1.3.4. Impact measurement

In order to be able to analyse these metrics, they have to be measured. In the GIIN industry snapshot (Mudaliar & Barra, 2015), 96% of sampled funds use S&E performance metrics.

The results obtained from measurements affect four key stakeholders. First, investors are interested in the effect of their capital on wider S&E goals, including timescales and level of risk. Second, fund managers wish to benchmark the effectiveness of different investments within their fund (and to compare these to other industry players) over time. Third, investees may wish to use metrics to determine progress and scope for improvement. Finally, wider beneficiaries may wish to engage in the measurement process to influence the investment process (Reeder, Colantonio, Loder, & Jones, 2015, p. 4). An important notion to explore is that of the *Impact value chain*, developed by the European Venture Philanthropy Association (EVPA).

Figure 7: Impact value chain

Planned work		Intended results		
1. Inputs	2. Activities	3. Outputs	4. Outcomes	5. Impact
Resources (capital, human) invested in the activity	Concrete actions of the investee	Tangible products from the activity	Changes resulting from the activity	Outcomes adjusted for what would have happened anyway, actions of others & for unintended consequences
EUR invested, number of people, etc.	Development and implementation of programs, building new infrastructure, etc.	Number of people reached, items sold, etc.	Effects on target population e.g. increased access to education	Attributions to changes in outcome. Take account of alternative programs e.g. open air classes
EUR 50k invested, 5 people working on the project	Land bought, school designed & built	New school built with 32 places	Students with increased access to education: 8	Students with access to education not including those with alternatives

Source: EVPA, researcher

This framework makes clear distinctions between the "inputs" (1) in a given process, the "activities" (2) that use those inputs to achieve the objectives, the "outputs" (3) which are the tangible products and services produced by the organisation, which in turn creates directly imputable change known as "outcomes" (4) which enable the assessment of "Impact" (5), defined as "the attribution of an organisation’s activities to broader and longer-term outcomes" (Dr Hehenberger, Harling, & Scholten, 2015, p. 17). It separates an organisation’s planned work (1-2) from its intended results (3-5). The Social Performance Taskforce ("SPTF"), an organisation established under the United Kingdom's presidency of the G8, highlighted seven best practices guidelines. In order to achieve their intended Impact outcomes, LP should require fund managers to set goals, develop frameworks & select metrics, collect & store data, validate data, analyse data, report on data and finally make data-driven investment management decisions (Social Impact Investment Taskforce, 2014). The last point is important, as it highlights the requirement that fund managers behave rationally given their mandate.

The Word Economic Forum (2013) identifies four key reasons why measurement is a challenge to Impact Investors. First, lack of homogeneity and standardised measurement metrics hinder comparisons between relative performance and benefits generated across projects. There has been progress with the development of international initiatives, such as the IRIS initiative of the Global Impact Investing Network (GIIN, 2013), The Global Impact Investing Rating System (GIIRS), which is a rigorous, comprehensive, and comparable rating system of a company or a fund's S&E Impact (B.Lab, 2013), or alternatively the Global Reporting Initiative (GRI), which provides organizations with a comprehensive sustainability reporting framework, enabling them to measure and report their S&E performance. Second, the time horizons required to measure Impact often exceed those of the investment horizon. The preferred time of exit for traditional PE is between 3-5 years from time of investment; however, results from social enterprises such as those in infrastructure or education can take decades for the full results to become apparent. Third, there is high cost to measuring outcomes. Significant resources may need to be diverted from the primary operations to generate the required information. Lastly, there is a problem linked to the causality in attributing success to a project. In dynamic, complex social systems there are a multitude of factors that can influence outcomes. Isolating the Impact from the given project for measurement can be highly challenging, as Impact requires that an investment increase the quantity or quality of the enterprise's social output beyond what would otherwise have occurred (Brest & Born, 2013).

2.1.4. Limitations to Impact Investing

For three consecutive years, the GIIN's industry surveys have highlighted "Lack of appropriate capital across the risk/return spectrum" and " Shortage of high quality investment opportunities with track record" as the top two challenges (Saltuk, Bouri, Mudaliar, & Pease, 2013; Saltuk, El Idrissi, Bouri, Mudaliar, & Schiff, 2014; Saltuk et al., 2015). Interestingly, Brest (2013) considers that the lack of investment opportunities, often due to imperfect information, is an opportunity for Impact Investors. Traditional investors may not be aware of particular opportunities and their risk/return profiles (especially enterprises in developing nations or in low-income areas in developed nations). This is positive for Impact Investors who have a depth of knowledge in these sectors and geographies. The third biggest challenge is the difficulty to exit deals, as many developing economies have markets that are insufficiently developed to offer reliable options for investors to exit investments within a reasonable timeframe. A widespread concern is the small size of Impact Investing deals (Brest & Born, 2013; Monitor Institute, 2009; Saltuk et al., 2015; World Economic Forum, 2013). The typical Impact Investment is often smaller than similar PE investments. Furthermore, even for transactions that offer market rate returns, small deals result in small absolute returns. Those small returns still come with an initial, mostly fixed, transactional cost to the Impact Investor. The consequence is that the minimum cost of DD and other transaction costs can render the investment financially unattractive. To cite a few, the lack of a common Impact Investing language, lack of investment professionals with relevant skill sets and governance problems, especially in developing nations where there are uncertainties about property rights and contract enforcement, and where bribery is a key limitations.

Finally, lack of innovative deal/fund structures to accommodate investors' or portfolio companies' needs is a challenge directly relating to the deal's TSs. As noted by Brest (2013), institutional investors may use heuristics to simplify decision making and as a consequence exclude potential Impact Investments, which, for example, may require more flexibility than the fund's practices permit.

2.1.5. Impact Investing in SSA

Since 2000, the size of SSA's economy has more than quadrupled. The main growth drivers are investment in infrastructure, a robust services sector and strong agricultural production, especially in the region's lower-income countries. African economies have continued to diversify and are among the fastest growing in the world: growth rates have exceeded 7% over a sustained period in some countries (Ernst & Young, 2015). Despite these impressive figures, the quality of life of many Africans has not kept pace. According to 2008 data from the World Bank, 47.5% of people in SSA lived on less than USD1.25 per day, which is the international standard for extreme poverty. Almost all Africans (97%) fall into the category of a "low-income market" as defined by the IFC, earning less than USD 8 per day (International Monetary Fund, 2014). This paradox underlines the key challenges faced by

African countries: to sustain the economic growth rates already achieved while adequately addressing key bottlenecks to S&E development.

The key demand sectors in SSA are access to healthcare services, access to financial services, access to education, agriculture and food security (with a focus on better nutrition), infrastructure, access to energy (with a focus on renewables), water infrastructure and affordable housing, to name a few. All these categories are aligned with the focus of Impact Investors. There is vast potential for Impact Investing in SSA. From the demand side, it is estimated that the demand for SME finance in Africa is estimated at USD 140b for early-stage enterprises (UNDP, 2014). It is important to note that this number does not exclusively account for companies dedicated to addressing S&E challenges, but is a good approximation as many specialists consider SMEs to be crucial to economic development. It is estimated that the total development financing gap in Africa will be USD 100b annually until 2030.

On the supply side, foreign investors dominate capital deployment in SSA. However, despite DFIs contributing to 18% of accumulated reported Impact Investments in 2015, only 14% of the total volume was deployed in SSA, amounting to approximately USD 8.4b (Saltuk et al., 2015). Supply of Impact capital is expected to rise, as different types of investors begin to enter (and consolidate) the market. Emerging market Impact Investment funds have returned 9.1% to investors versus 4.8% for developed market Impact Investment funds. Those focused on SSA have performed particularly well, returning 9.7%.(Matthews et al., 2015). While funds are struggling to find value in "conventional" markets, these figures highlight the opportunities available in the Impact Investing space from a commercial perspective. In addition, a recent report by Morgan Stanley has highlighted that millennials are twice as likely to both invest in companies or funds that target specific S&E outcomes and to divest because of objectionable corporate activity (Morgan Stanley, 2015). As this generation takes a stronger position in terms of capital ownership, we can expect an increase in capital deployment towards the Impact Investing asset class, with indirect benefits to African SMEs.

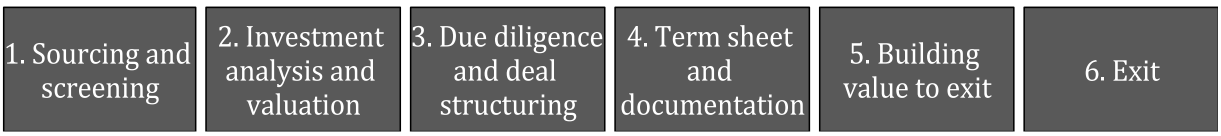
African governments are increasingly recognising the potential of impact investment business to contribute to sustainable growth. Acceleration hubs, local business schools, and think tanks are adopting these new concepts, while research into and development of new solutions is increasingly taking place within local institutions. Increasing confidence by governments and philanthropists regarding cooperation with the private sector, after finding that capital deployed with positive intention is both effective and critical in catalysing solutions for social challenges such as poverty, job creation, environmental challenges, and others (UNDP, 2014).

As the industry matures, Impact Investing hubs are emerging, particularly in regions where socio-economic challenges can be addressed through the particular investment type. East Africa has emerged as one of the centres of global Impact Investing. USD 1.4b in Impact capital has been deployed across the region by non-DFI Impact Investors, and a further USD 7.9b has been deployed by DFIs. In total, there are currently 155 Impact Investors managing 206 active investment vehicles in the region, and many more are considering the region for future commitments (Saltuk et al., 2015). Nairobi has become the regional hub for Impact Investing in East-Africa. Not only has almost half of the Impact capital disbursed in East Africa to date been disbursed in Kenya, but approximately 50 Impact fund managers have staff placed in Nairobi. Kenya also hosts the largest supporting ecosystem in the region, with more than 30 different organizations, such as accelerators, incubators, advisors, intermediaries, etc.

2.2. Impact Investment deal cycle

The Impact Investing deal cycle, also referred to as the investment process, can be divided into five inter-dependent stages, as illustrated in Figure 8. As a professional process, the information on the deal cycle is largely based on the book titled, "Impact Investment - A Practical Guide to Investment Process and Social Impact Analysis" (Allman & Escobar de Nogales, 2015).

Figure 8: Impact Investment deal cycle



Source: Allman & Escobar de Nogales, 2015

2.2.1. Sourcing and screening

This initial phase of the investment process involves identifying potential investments. Investors source these opportunities based on an investment thesis that they and their LP believe in. Industry jargon for this refers to "pipeline", or "deal sourcing". Collecting, monitoring and evaluating potential investments demand time and capital resources.

Therefore, it is crucial that these investment opportunities fit into the strategy, and *vice-versa*. In one survey, This key phase in the deal cycle is stated as the second biggest challenge in the Impact Investing industry (Saltuk et al., 2015). Despite this process seeming to be quite straightforward, Allman & Escobar de Nogales (2015) identify certain key challenges. First of all, the Investor operates under constraints. The first constraint is time. The longer the Investor waits to invest, the further away their potential exit (and therefore the potential gain on capital). The second main constraint is capital. It costs money to undertake onsite DDs, consult lawyers and advisors. Therefore, efficiency is required to minimise upfront costs. It is crucial to be able to identify regions, economies and industries that are investable. The S&E mission of the potential investment must also be analysed and compared to the Investor's S&E investment thesis. The final constraint is competition. As there is a lack of quality deal with strong track records, many Investors will bid on the same opportunity, driving the price of acquisition to higher valuations.

2.2.2. Investment analysis and valuation

Once the Investor has identified attractive investment opportunities in the screening phase, he then proceeds to what is commonly called the "desktop" DD. This process consists of analysing the company's key financial, operational and managerial potential, as well as the S&E mission. By first conducting a desktop DD, the Investor can identify early signs that could be deal-breakers, and avoid any additional expenditures. This phase is particularly important for equity Investors, who require to start valuation conversations early on in the investment phase. This is to avoid any gaps in the perceived value. The result is a range of valuations that will be fine-tuned and confirmed during the DD phase. Although valuation is not the subject of this research, it is important to note its importance within the Impact Investing sector, as the LP have a wide range of return expectations and risk appetite. Return expectations cause a wide variation in the cost of capital.

2.2.3. DD and deal structuring

Once the Investor has concluded that the company is worth investing in, the Investor will continue the analysis with an onsite DD. This process reviews all managerial, operational and financial aspects, and analyses competition and the S&E mission achievement plan. Through this process, Investors will be able to assess the investment structure and further understand the investee's capital requirements. Debt Investors will valuate collateral value and the potential for cash flow generation, as well as key risks and mitigants. PE Investors will stress their assumptions to determine the valuation range. If the Investors are still interested in investing after this stage, a negotiation will follow regarding the deal structure. PD Investors will negotiate covenants on their priority over cash flow or collateral, while equity Investors will agree on a valuation and negotiate preferential rights. It is crucial to align the S&E objectives of the Investor and the investee to ensure that they will remain aligned after the capital disbursement.

2.2.4. TS and documentation

After having negotiated the key elements of the deal, these elements are compiled into a TS. The TS covers the investment structure, preferences and specific rights for all parties involved in the transaction. Once the document is agreed on and signed, it will serve as the basis for the final document. For PD Investors, the TS will serve as a basis for the loan agreement. For PE Investors, it will result in a subscription agreement, to which a shareholders agreement is drafted to protect the different shareholders' rights. For PD Investors, it will result in a loan agreement. This stage will be analysed in detail in section 4.3.

2.2.5. Building value to exit

After having signed and disbursed the capital, the company enters into a phase of building value during the holding period. For debt Investors, the returns are mainly generated through principal amortisation and interest repayment. For equity Investors, value is created mostly upon exit, with recurring cash flows in the form of dividends. Passive equity Investors will be more focussed on reporting and analysing financial metrics, while active equity Investors will take part in Board meetings to develop the company's strategy.

2.2.6. Exit

The exit phase of the investment, which is particularly crucial for equity Investors, is cited as the third biggest challenge in the industry (Saltuk et al., 2015). At a certain point, investments must be exited to realise returns that meet the LP' requirements. A study by Ernst & Young on PE in SSA (2015) indicates that the main route for exits is trade sales (55% of exits in 2014), followed by secondary transactions. In Impact Investing, exits have an added complexity. Investors require that the company continues to follow the same S&E mission after the exit, and this requires that the buyer (if not an IPO) is also aligned with the S&E mission.

2.3. TSs in Impact Investing

Investments are rarely made on verbal agreements alone. Ultimately, all the parties' rights and protections are laid out in a legal document. The terms of this legal document are laid out in the TS. It is important to understand that a TS is not a legal document in itself, and is not binding unless specified otherwise. It is the basis on which the legal, binding documents are created. The intent is to have a common agreement before utilising additional resources, such as legal teams or internal teams for DD. As highlighted by Allman & Escobar De Nogales (2015), Impact Investing has a certain number of specific clauses related to the investments. As Impact Investors generally aim to provide goods and services to a socioeconomic group that was previously underserved, they may drift from their initial mission and serve higher-income segments. Investors want to protect their interests by ensuring that the company stays with the initial mission by including clauses into the binding documents. This topic will be explored in detail in section 4.

3. RESEARCH METHODOLOGY

By taking an inductive approach, the researcher intends to undertake qualitative research based on case studies of three Impact Investors through semi-structured interviews and in-depth analysis of selected TSs.

3.1. Research approach and methodology

The researcher is taking a constructivist approach to the study. Constructivism is a philosophical worldview that seeks to understand the world in which individuals live and work. In order to do so, constructivists develop subjective meanings of their experiences and the complexities in which they are interlinked. The researcher relies as much as possible on the participants' views. By nature, constructivism seeks to explore qualitative information and build theory. The ideas came from Mannheim and from works such as Berger and Luekmann’s (1967) The Social Construction of Reality and Lincoln and Guba’s (1985) Naturalistic Inquiry.

Furthermore, the study will be based on qualitative research. As defined by John Creswell, *"Qualitative research is an approach for exploring and understanding the meaning individuals or groups ascribe to a social or human problem. The process of research involves emerging questions and procedures, data typically collected in the participant’s setting, data analysis inductively building from particulars to general themes, and the researcher making interpretations of the meaning of the data"* (Creswell, 2014). By exploring different experiences, documentation and anecdotes, the data will be compiled in order to determine best practices.

The research method is case studies. Case studies are a design of inquiry found in many fields, especially evaluation, in which the researcher develops an in-depth analysis of a case or a process of one or more individuals. Cases are bounded by time and activity, and researchers collect detailed information using a variety of data collection procedures over a sustained period of time (Stake, 1995). A case is also defined as “a research strategy which focuses on understanding the dynamics present in a single setting” (Eisenhardt, 1989). As the research is in a new topic area, case studies are particularly appropriate.

3.2. Data collection, frequency and choice of data

Regarding the sampling process, there are two elements that need to be noted. First, the types of companies that are being studied are unlisted and disclose a limited amount of information. Publicly available information is scarce and these small organizations evolve in a tight ecosystem. The selection of the interviewed funds is mainly based on the researcher's network. However, there are a certain number of key characteristics to which the sample must comply. First, the company must fulfil the "four pillars" of Impact Investing. Second, the company must necessarily have a footprint in SSA. This can either be in the form of a local office or in at least one investment in the region. Third, the study intends to include at least one PE provider and one PD provider. The point is to be able to compare the two types of institutions, which differ significantly in the way they structure their investments. Within the fund, the research relies on expert sampling. This sampling method selects the participants based on their expertise and unique knowledge of the subject of interest. Although this is a bias in the research, it will allow the identification of unique information. The interviewees who will participate in the study are selected upon availability and authorised by the company.

The data collection process, identically replicated between each fund manager, is as following. In phase 1, an initial interview was conducted with a fund representative. The targeted person was at executive level and had an in depth knowledge of the company, the history, the values, etc. The main topics of discussion were an overview of the fund, information on governance, deal structuring processes and the TSs. Following the introductory interview, phase two took place as a conversation with an employee specialised in S&E Impact. The objective here was to obtain an in-depth understanding of the company's Impact goals all along the investment process, the monitoring, reporting, covenant enforcing, etc. The third phase of the data collection took the form of a documentation review. At least three TS of selected deals were studied in depth in order to identify key features. These features should highlight among others innovation, tailoring and enforcement in case of breach of covenant clauses. The fund manager selected these TS. Due to the highly confidential nature of the documents, the researcher would, unless expressly authorised by the interviewee company, access the documents on the company's premises. Finally, and after an in depth understanding of the company's practices, the researcher had a follow-up conversation with an investment professional in phase four. This conversation was based on observations made during the document review phase, in addition to a set of open-ended questions. The person interviewed was an investment professional who had been involved in the studied TS. The anecdotes provided by this person were critical in order to isolate success factors. Primary data was collected during the interview phases (phase 1, 2 and 4) and secondary data was collected during the documentation review phase (phase 3).

The average time spent with each fund manager was of one working day, with approximately half of the time dedicated to the interviews and the other half dedicated to the documentation review. A follow-up conversation was undertaken at a later stage to obtain additional information, upon request and availability.

4. TERM SHEETS IN IMPACT INVESTING – A BEST PRACTICE GUIDE

4.1. Introduction

In order to compile, analyse and discuss the material which follows, the researcher has, as planned, interviewed a total of three Impact Investing fund managers that fulfil the sampling criteria, as illustrated in the table below.

Table 4: Sampling criteria of studied fund managers

	Bamboo Finance	Blue Orchard	CDC Group
Intentionality	Provides goods and services to low-income communities	Provides services to previously underserved or excluded communities to access financial services	CDC supports the building of businesses to create jobs and make a lasting difference to people’s lives in some of the world’s poorest places
Financial returns	Commercial returns	Commercial returns	Commercial returns
Defined asset class and range of returns	Private Equity	Private debt	Blend
Active measurement	BF Impact report	SMART	CDC Toolkit
4 pillars	Yes	Yes	Yes
Presence in Africa	Yes	Yes	Yes

Each fund gave access to key employees (executives, investment managers and heads of S&E). A total of 9 professionals were interviewed. The researcher conducted the interviews in the physical presence of the professionals in Geneva, Switzerland and London, United Kingdom, as well as a number of phone and Skype calls. The secondary data, collected by analysing executed legal documents and templates, was compiled based on 13 documents, including 3 templates[4], 1 Loan agreements, 3 term sheets, 3 SPAs and 3 SHAs. To the researcher's surprise, the documents were sent to him under an NDA, and he was therefore able to spend more time on reading and analysing the documents. As an indication, each document size ranges between 4 and 60 pages, depending on the document.

By nature, the TS is a highly sophisticated document, which is not meant to be reader-friendly. The researcher, to the best of his capacity, has included real examples and investment highlights in order to bring such a document into context.

[4] The CDC exclusively provided templates; specific transaction terms may vary

4.2. Case studies

4.2.1. Bamboo Finance ("BF")

BF defines itself as a commercial PE Impact Investor. BF targets organisations that provide goods and services to low-income communities. Currently, the company manages over USD 250m. It offers a combination of attractive financial returns to its investors alongside creating S&E value through a market-oriented investment approach. After having launched in 2007, BF invested in 46 companies that operate in 30 emerging market countries. Through its portfolio, BF has provided goods and services to over 18 million clients and has created over 20'000 jobs. BF has its headquarters in Geneva and has regional offices in Luxemburg, Singapore, Bogota and Nairobi. Currently, BF manages two funds. First, the Financial Inclusion Fund ("BFIF") provides equity financing in companies that improve access to financial services for low-income communities in growth markets. Based on this investment thesis, BF raised USD 195m and invested in 30 companies. Through the investments, BF accompanied a number of investee companies through transformations that led them from being non-deposit taking institutions to becoming commercial banks offering a full range of financial services. BF has exited 4 investments. The second fund is the Oasis Fund ("BFOF"). USD 46m is invested in 16 companies in Asia, SSA and Latin America, with the objective of financing businesses serving low income people in sectors such as energy, education and healthcare.

4.2.2. Blue Orchard ("BO")

BO is a leading global Impact Investment manager, offering premium investment solutions through debt and equity financing to institutions in emerging and frontier markets. The company was founded in 2001 as an initiative of the United Nations to be the first commercial manager of microfinance debt. Since then, BO has invested over USD 3b in 300 institutions across 60 countries. Through these investments, BO has allowed over 20m people who were previously underserved or excluded to access financial services. With headquarters in Geneva, they have local offices in Lima, Zurich, Luxemburg, Nairobi, Phnom Penh and Tbilisi. The company offers services in four key areas, which are fund management, advisory, technical assistance and public private partnerships ("PPP"). BO manages the BlueOrchard Microfinance Fund ("BOMF") as well as customised mandates. The BOMF is the first private and fully commercial microfinance investment fund in the world. Since inception, it has been returning an annualised return of 4.35% to its investors alongside generating significant S&E Impact. The fund is a pure fixed-income fund that invests in microfinance institutions in emerging and frontier markets to help them in expanding their outreach, improving the quality and appropriateness of their financial services, and encouraging the development of new products such as savings, insurance and payment services. It has the novelty of systematically hedging currency risk. The fund is open-ended and includes institutional and private investors. It is important to highlight that BO manages specialised Impact Investing funds such as the Climate Insurance Fund ("CIF"), the Microfinance Enhancement Fund ("MEF"), the Microfinance Growth Fund, the Microfinance Initiative for Asia ("MIFA") and the Regional Education Finance Fund for SSA (REFFA). BO has developed an S&E performance management tool named SPIRIT, the Social Performance Impact Reporting & Intelligence Tool. This framework focusses on seven key areas of S&E Impact, aligned with the Universal Standards on Social Performance Management. A deep dive into the framework is available in appendix 8.3.

4.2.3. CDC Group ("CDC")

CDC Group plc (formerly the Commonwealth Development Corporation, and prior to that, the Colonial Development Corporation) is a Development Finance Institution owned by the UK Government founded in 1948. CDC's mission is to support the building of businesses throughout SSA and South Asia. It is especially focussed on creating jobs and lasting differences in people's lives in some of the poorest places in the world. At the end of 2014, CDC's portfolio was valued at GBP 3.4b and includes 1331 investee businesses. In 2014, the portfolio companies employed a total of 1.1m people and paid GBP 1.5b in local taxes. The company's business model is to redeploy any profits or principles returned after the sales of shares or the loan redemptions. Typically, CDC would provide direct investments in equity, debt, mezzanine finance and guarantees or indirect investments into funds that are aligned with CDC's ethos.

4.3. Term sheets and legal documentation overview

"TS" will be used interchangeably when referring to the memorandum of understanding, the TS, and more broadly, to the letter of intent. Collectively, these three terms differ marginally and for the sake of simplicity, they will be referred to as "TSs". The following sections will highlight the main components of a TS relating to an equity investment. As the focus of the research is the novelty of Impact Investing TSs, the structure and content of the legal document will not be explored in too much detail for reasons of efficiency. The choice of the instrument is due to its higher complexity compared to debt. Although the two documents resemble each other in form, the content differs significantly. As an illustration, the researcher has drafted a fictitious Impact Investing loan document, which is available as an appendix.

Corporate investments are rarely based on verbal agreements alone. These agreements are usually complex, and require an understanding of the needs and constraints that both parties face in an agreement. PE, and more broadly private capital markets, are based on binding documents that govern the transaction in the form of agreements and articles. Prior to reaching such an agreement, a TS would typically be laid out. The purpose is to make sure that the parties are aligned before mobilising resources towards a targeted transaction.

Impact Investing TSs should differ from conventional TSs, as the investor will ultimately want to gain comfort on the protection of its Impact focus. Although TSs vary from fund manager to fund manager, and further, from investment to investment, the main sections are highlighted in the following.

4.3.1. Definition

The TS initially identifies the Company, the parties involved in the transaction and the investment type. Usually, it will also define wording for the rest of the document. For example, the Impact Investor, described initially in its entirety (name, place of incorporation, address, and key people) will be referred to as "the Investor".

4.3.2. Transaction details

Once that the parties involved and the investment focus and type are described, the next section will cover the details of the transaction. First of all, the document should detail the exact amount being invested, as well as the currency. Furthermore, the indicative valuation will also be included, which allows the document to detail the number of shares being acquired, the value per share and the equity stake bought by the Investor. Depending on whether the investment is simply buying out specific shareholders or increasing the overall equity value, the change in capital structure would also be indicated.

4.3.3. Protective clauses for shareholders

Different investments have different protective requirements for the Investor. This is typically applicable to minority shareholders (usually in the range of 10-49%), who require minority rights. These come in the form of Board approval powers and shareholder requirements. These rights commonly refer to changes in company bylaws or incorporation documents, emission of new shares, approval of any sale of assets, mergers and acquisitions above a certain threshold, approval of the liquidation of the company, dividend pay-outs and change in Board structure.

4.3.4. Protective clauses for Boards of Directors

To complement the shareholders' rights, the minority shareholder will usually require the right to appoint at least one voting Director. On certain critical issues, a minority Investor can ask for approval or veto rights. These rights commonly refer to changes in the number of Directors serving on the Board, transfer of licenses or intellectual property, changes in compensation of executive management, amendments or approval of the annual business plan and the commitment of capital expenditure and new debt or investments in excess of a certain threshold.

4.3.5. Conditions precedent and subsequent

Condition precedents are milestones that need to be reached prior to the execution of the binding documentation. There are three critical components to a condition precedent or subsequent:

- Establishing the necessary action required (further on, we will refer to this as the "Action Plan");
- Setting the event to which the action is precedent or subsequent; and
- Creating the method for verifying that the condition is satisfied.

The most common conditions precedent are completion of business, legal, accounting and technical DD, as well as receiving regulatory approval to accommodate the new Investor.

4.3.6. Board composition and governance

This section will focus on defining the Board composition and how the company is governed. The three levels of governance (shareholders, Board of Directors and Management) will be detailed further. This section is critical, as most important decisions relating to the business are made at the Board level. Among others, this section will detail the number of Directors, the number of Directors required to reach a *quorum*, the actions required to call a Board meeting as well as the mode of submission for all important documents and agenda and finally which decisions are made at which majority (simple majority (50.1%), super majority (e.g. above 50%) and any other decision requirement that is appropriate to the Board composition.

4.3.7. *Purchase, sale and conversion rights*

A number of rights are discussed and negotiated around share purchasing, selling and converting. The point is to preserve as much value for both the company and the shareholders. The most important element for an Investor is anti-dilution rights, as he may fear that the emission of new shares may significantly reduce his stake and therefore decision power. This is usually due to sales of shares at lower valuations than in the previous round. A common covenant is pre-emptive rights. This would give the shareholder the first option rights to purchase newly emitted shares.

4.3.8. *Founder/management restrictions*

Especially in early stage investing, an Impact Investor will link the potential success to the company's management. The number of shares purchased and the remaining shares held by the entrepreneurs is an important incentive to maintain and develop the output according to the business plan. For example, an Investor can require that as long as he is invested, the founders may not sell off their shares to a third party. In certain instances, the reason why an entrepreneur is selling his shares is to be able to reduce or terminate his involvement in the business. An appropriate solution is therefore that the entrepreneur is restricted to a certain holding period, after which he can sell his shares.

4.4. Term sheet drafting

Depending on the choice of the financial instrument, there are significant differences to note in the TS drafting. Typically, an equity investment will require extensive governance from the Investor, whereas debt would require foreseeing the future S&E events and targets. In the following, we will explore the main elements in the TS drafting process and the follow on documentation. The way this document intends to highlight the key findings is by showing the analysed covenants that were extracted from actual TSs provided by participating funds. In order to comply with confidentiality agreements, the covenants have been slightly modified to remove, as much as possible, any link to the investee. All resemblance with actual investments is a coincidence and is not the researcher's intention.

4.4.1. Equity

In PE, the TS is part of a larger group of legal documents that include the shareholders agreement ("SHA"), the share purchase agreement ("SPA"), a non-binding TS (also referred to as a non-binding offer, "NBO") and a binding TS (also referred to as the binding offer).

The NBO is drafted and submitted prior to DD, and includes non-binding terms such as the preliminary valuation of the target company. After having conducted the onsite DD and reviewed amongst other things operations, financing, S&E practices and strategy, the Investor would decide on the final terms to which he would want to be bound. However, this is usually still subject to investment committee, legal and fiscal approval. At this point, the majority of elements to be included in the binding offer are determined. This is then submitted to the investee.

At this point, the SPA and SHA are usually drafted. However, in order for the Investor to disburse capital, there are clauses on "conditions precedent". These conditions are the final hurdle prior to purchasing the shares and entering into the shareholders group. The conditions generally include the signing of the SHA, the finalisation of the legal and fiscal DD, and certain changes in the institution. The latter includes, in some cases, S&E requirements.

Initial findings conclude that the TSs are more or less consistent from one investment to another. Usually, the difference lies in the choice of jurisdiction, the number of Board seats, the valuation and the minority rights. One of the key elements communicated to the potential investee is the exit requirements (exit horizon, drag along rights, put options, IPO target and appointment of an investment bank).

4.4.2. Debt

PD TSs are highly consistent between one investment and another, and this has been confirmed throughout the research. The final documentation (binding) is the loan agreement.

To take this further, most PD providers would have a "one size fits all" template, which would be linked to annexes containing the requirements of specific mandates. These can easily be switched depending on the mandate and investee. The reason for this is that, due to the nature of the instrument, there is usually a higher number of transactions and shorter holding periods than in PE. It would not be efficient to tailor each TS on a case by case basis.

First, drafting the document requires legal review and advisory. For most Impact Investors, which are "back-office light", this would require external advisory, which are both costly in terms of financing and time. Therefore, the document would be developed to be easily adjusted to each mandate. Second, TSs are provided to the investee on a non-binding basis. This would reinforce the fact that it should remain light, as it forms the basis for the actual loan agreement. Finally, the TS is provided prior to the DD. It is at this stage that the S&E requirements can be assessed, following which they would be included in the loan agreement.

4.5. Protecting the LP's values

Before diving into the details of the term sheet in Impact Investing content, it is important to discuss certain key elements that protect the LP interest (the upstream contractual group). This question was born due to the fact that there is more and more interest in the Impact Investing field from a wide range of investors. The investment conditions are described in the prospectus, a binding document between the LP and the Impact Investor.

Often, the fact that the Investor is investing the LP's capital within a defined perimeter (industry, customer base, geography, among others) is sufficient in the eyes of the LP to take comfort in the productive use of his capital.

4.5.1. The relevance of the LP's values

Before any further research in the actual TSs, interesting elements came up during one of the interviews. In many cases, Private LP are not particularly interested in receiving complex reporting documents and information that they cannot understand, especially for private investors. When investing, the LP knows what kind of business model he is providing his capital to, and is therefore satisfied by putting it to productive use. He is motivated by receiving financial returns, and therefore does not necessarily require that the fund manager spends more money and time than necessary: these additional costs are a burden and, *in fine*, reduce financial returns.

On the other hand, DFIs are particularly socially motivated. As highlighted by an interviewee, this is due to the political agenda. For example, a DFI would require a number of elements to be put into the TSs. When DFIs provide capital to fund managers, they do this either by investing in a fund that is pre-existent and marketed by the Impact Investor, or they provide a pocket of capital that is intended for a specific purpose (mandate, or managed account). In this case, fund managers bid to obtain this mandate. DFIs would typically look at the management team, the track record, presence in the targeted geography, management fees, expertise in a certain industry, and so on. By doing so, the DFI is making the rules of the game.

4.5.2. Remuneration

The way in which fund managers are compensated is crucial in order to incentivise them to attain financial and S&E objectives. Compensation differs depending on the fund strategy, more specifically depending on the financial instrument used. However, in both cases, the basis for the compensation is a management fee charged by the fund manager to its investors. The management fee is a percentage of either the total assets under management (AUM) or the total invested capital. Most investors require a payment based on invested capital. This raises concerns for the fund managers, as there are significant costs linked to liquidity management. On the other hand, the investors want to make sure that there is an incentive to constantly remain as invested as possible: cash has almost no return. As the fund manager has fiduciary duties and return objectives, he will naturally tend to remain as invested as possible in order to maximise the financial returns.

Equity Investors have what is called a hurdle rate, which is the minimum return requirement in order for the fund manager to receive a "performance bonus". This performance bonus is called the carried interest, which is calculated as a percentage of the revenue generated above the hurdle rate. The purpose is to incentivise the investment teams to make good investments, which generate financial returns as close as possible to the target IRR.

Debt Investors generate most of their revenue from the management fee. However, there are a number of performance bonuses that are put into place, depending on the contractual agreement. For instance, some of the interviewee's managed accounts pay a performance fee. The performance fee requires specific targets, set up by the Boards of the funds. If the targets are reached, there is upside.

There is currently some interest from institutional investors to put together an "S&E carried interest". One of the interviewees has been developing such a structure and gradually introducing new terms to the market. This would be an additional percentage to the financial carried interest if certain S&E objectives are achieved; however they usually require an external rating agency. One area where this structure is particularly applicable is through a managed mandate. For instance, certain DFIs could put together a request for proposal that targets a very narrow investment scope, linked to specific S&E targets. This would in turn facilitate the S&E performance assessment, since the targets are well defined *ex ante*. Unfortunately, there are currently very few funds which have put such an incentive into place. In practice, an interviewee indicated that S&E performance based remuneration is difficult to implement on a portfolio level, as opposed to on a deal by deal level.

4.6. S&E covenants

As an introduction to S&E covenants, the researched intends to highlight the substance and use of the clauses within the financing contracts. Practitioners will recognise familiar components, here adjusted to accommodate the Investor's values.

S&E covenants are positive or negative clauses relating to S&E objectives. Positive covenants refer to an obligation and negative covenants refer to a restriction for the investee. Much like financial covenants, they require transparency from the investee, efficient monitoring processes and regular reporting.

Before looking at TS specifics, it is important to assess the point at which S&E covenants come into the conversation between the parties involved in the transaction. S&E nuances differ highly from one investment to another. A microfinance investment has a different S&E Impact profile than a renewable energy one, which in consequence causes the S&E requirements to not be comparable on an equal basis. During the DD phase, there is an opportunity to assess what S&E requirements are appropriate. For example, one would look at what kind of consumer protection laws are being applied. Do they have an S&E mission? Is the Board involved? Do they meet the S&E objectives? These are all questions that can only be answered by being onsite and looking at the S&E status quo. This allows one to go beyond just conversation and getting comfortable with the target acquisition.

The following covenant highlights representations and warranties. This focuses on the current status and the past of the company in order to avoid any unexpected occurrences that are beyond the Investor's control. In particular, one of the key elements is ESG compliance. ESG compliance would differ depending on the industry as well as the regulations under which the company is governed. For example, in South Africa, Governance requirements could relate to BEE requirements or CO_2 emission reduction goals.

1. **From the Company**

   The company will give full representations and warranties for this type of transaction, subject to disclosure. Subject to any matters arising in DD, they will cover organisations and good standing; capital structure; no outstanding share options, no litigations, no material infringement of any third party's rights; agreements with employees; no encumbrances; good title to all material assets; tax liabilities; tax returns and corporate records complete in material respects; accuracy of financial statements (including management accounts); accuracy of material provided to Investors; and ESG compliance.

2. **From management**

   Management will give limited representations and warranties concerning key issues for the investors. The warranties will be subject to disclosure and, in relation to Company matters, the manager's actual knowledge. The representations will cover due preparation of business plans and forecasts; accuracy of information provided; ESG compliance; Manager's personal interests including no convictions or disqualification; no charges on Management shares; no obligations or liabilities of Company to Managers; and no restrictions on Managers imposed by former employers. Liability will be limited to one times annual salary.

Covenant 1: Representations and warranties

Monitoring and reporting requirements are not exclusive to Impact Investing. Most investees will systematically report on a number of predetermined elements. From an S&E perspective, the interviewees would typically require reporting metrics on rural/urban consumers, number of women employees, number of women clients, the nature of the products provided to the clients, etc. As one of the key requirements for Impact Investors is to actively monitor S&E indicators, the contract needs to stipulate how and when the metrics are delivered. Best practices suggest that these metrics should be monitored on a quarterly basis. For instance, recurring reports need to have a submission delay. The following covenant also covers the occurrence of unforeseen events to which the shareholder should immediately be alerted.

From the date of this Agreement, the Borrower shall:

a) Within ninety (90) days after the end of each financial year, deliver to the Lender the S&E Performance Report;

b) Within ninety (90) days after the end of each financial year, deliver to the Lender a copy of the annual report prepared by the internal anti-money laundering and combating the financing of terrorism officer for the Borrower's senior management concerning anti-money laundering, combating the financing of terrorism and related matters;

c) Within three (3) days after becoming aware of the occurrence, notify Lender of any social, labour, health and safety, security or environmental incident, accident or circumstance with respect to any Client or in relation to any the Client Operations having, or which could reasonably be expected to have, any material adverse effect or a material adverse Impact on the implementation or operation of the Client Operations in compliance with the S&E Requirements, specifying in each case the nature of the incident, accident, or circumstance and the Impact or effect arising or likely to arise there from, and the measures being taken, or plans to be taken, to address them and prevent any future similar event; and keep the Lender informed of the on-going implementation of those measures.

Covenant 2: Reporting covenants

In addition to reporting obligations, the investee would also have to provide specific information, such as copies of Board papers and an update on ESG matters.

Each of the Investors requires standard information rights, including:

- […]
- A quarterly update on ESG matters and a full report annually;
- Copies of board papers;
- Prompt notification of:
    - […]
    - Any material breach by the group of its ESG obligations as set out above (including any alleged matters which, if proven, would constitute a breach), whether or not the matter would be result in a breach of applicable law.

Covenant 3: Information rights

The Investor would also require being able to access the company's premises and engage directly with stakeholders. This is guaranteed through inspection rights, as illustrated here-below.

The Investors may, either directly or through independent advisers (at the Company's cost), visit the Company's premises and inspect the Company's books in order to:

- Assess ESG performance and compliance;
- Compile any information that the Company was obliged to provide to the Investors but failed to do so.

Covenant 4: Inspection Rights

As mentioned before, one of the key covenants is the exit strategy and horizon. The following covenant exposes this concern as well as the explicit indication to the investee. ESG default, defined broadly, is sufficient to justify an exit either through trade sale (with drag along rights) as well as a forced IPO. In the researcher's opinion, the following covenant seems to be difficult to implement, as it remains broad and open to interpretation.

The investors wish to realise their investment in the Company by the 31st of December 2025. Management and the Company have prepared a business plan under which the Management and the Company will use all reasonable efforts to achieve an Exit by the date. If an Exit is not achieved by the predetermined date, if there is an ESG default, or the Company defaults in any payment due to the investors, the investor may • Sell their shares in a trade sale and drag the other shareholders along, including appointing corporate finance advisers on the shareholders' behalf; • Force an IPO of the Company's shares, including appointing an investment bank.

Covenant 5: Exit Strategy

It is interesting to question how the investee reacts to S&E covenants. As described by an interviewee, most companies in the scope of Impact Investors are socially motivated, and understand what the Investors are trying to achieve. This does not mean that the investee management wants to have many constraints around the way they manage their business. It is important to have a core set of principles that the management can refer to. However, unrealistic goals and constraining conditions are not necessary to achieve the development goals.

This section was purposely kept wide as it introduces the way covenants are modified to accommodate S&E requirements. In the following section, we will look at non S&E specific covenants, yet understand that they have (intentionally or not) important S&E implications.

4.7. Non S&E covenants

Know your customer, usually abridged as "KYC", is not considered an Impact Investing specific covenant. It is widely required in the financial industry, globally. When extrapolated to the Impact Investing industry, it takes a particularly social angle. As an example provided by BO, when investing in microfinance, the lender would have to perform usual checks on the customer. As one of the main goals of investing in microfinance is to reduce poverty, KYC is crucial not to over indebt the client. This would have both a negative Impact in the financial performance (default) and would also leave the client worse off than prior to the loan.

The Borrower shall promptly upon request of the Lender, supply or procure the supply of, such documentation and other evidence as is reasonably requested by the Lender in order for the Lender to carry out and be satisfied it has complied with all necessary "Know your customer" or other similar checks under all applicable laws and regulations relevant to the transactions contemplated in this agreement.

Covenant 6: Know Your Customer (KYC)

Anti-money laundering is another good example of a conventional covenant that is important in Impact Investing. Due to the regional focus, even more so for investments in SSA, particular caution needs to be taken in order to avoid misdirection of the capital. The entities to which the funds are usually lent are highly regulated and *de facto* comply with anti-money laundering.

The proceeds of the Loans shall be used exclusively by the borrower to grant Client Loans to existing or future customers of the Borrower and to refinance the existing indebtness of the Borrower. The Borrower shall not permit any of the Loan proceeds to be used to fund any form of violent political activity, terrorists or terrorist organizations, nor any money laundering process or scheme to disguise illegally obtained funds, nor any other criminal activity including arms sales, drug trafficking, robbery, fraud or racketeering.

Covenant 7: Anti-Money Laundering

One of the interviewees made an interesting point around financial covenants, which *in fine* have a dual effect. The first, which is more obvious, is to guarantee that the portfolio company performs in a healthy way, without exceeding certain leverage thresholds and monitoring the loans that they provide (in case of MFIs). There is a softer nuance, which is directly linked to S&E Impact. The covenant exposed below reflects the quality of the portfolio. Portfolio at risk ("PaR"), for example, is a metric that refers to loans that are late in their repayments. It is the universal measure of quality of a loan portfolio. It is set as the portion of the total portfolio that has a 5% probability of default in a thirty day period. In simpler terms, it measures the portion of total portfolio that is over-indebted.

The borrower shall at all times maintain the ratio of the sum of (X) portfolio at risk over thirty day + Restructured Loans + Net Charge-offs during the last 12 months divided by (y) the Outstanding gross loan portfolio of no less than 12%

Covenant 8: Example of a Financial Covenant

4.8. Technical assistance

Technical assistance ("TA") is a particular form of grant that is provided alongside the main investment. It can be used in both equity and debt transactions. TA can be in kind (non-financial), or not in kind (financial). The Investor has to ask himself how he is going to sponsor the program: do you transfer cash to the company and let them pay for the program? Do you pay consultants directly that you select and interact with? Or do you fund activities directly linked to the program, such as paying for marketing brochures, ad hoc training, etc. "In kind" TA provides services (consultants). The reason to do in kind is that it gives the investment team more control over the TA and at the same time allows the investment teams to remain focussed on their core activities. But each program has a best fit between those.

As an illustration, BO inherited the REFFA mandate after KfW[5] decided to it to a third party. KfW had already signed a deal with consultants on the overall package. Usually, an investment vehicle would manage two separate pools of capital under the same fund umbrella: one specifically for TA and one for investments. A certain Investor in the fund would provide the TA (usually a DFI). It is unlikely that private Investors would be involved in TA, as they are more motivated by financial returns. In general, and after having determined what the investee's needs are, fund managers would hire experienced consultants responsible for the TA. From an S&E perspective, TA has the potential to be extremely effective especially for smaller investments, as the investees are capital-constrained and do not have the "luxury" of hiring consultants. On the other side of the investment spectrum, most of the large investments require, for example, improvements on IT. This is an area for which TA is not appropriate, as it is limited in size and would not have a significant Impact on the company. In general, fund managers would add a cost-sharing component in order to align incentives. Based on the interviewees, the range of cost-sharing can be between 0% and 30%, which is added on top of the TA total budget.

[5] KfW is the main German DFI

4.8.1. *Legally binding*

As TA is usually part of the investment package, the conversation around the TA is included in the TS. However, it is dependent on DD. In most cases, the TA is to the investee's benefit and is provided on a discretionary basis. However, the TA can be tightly linked to the funds objective, for example in the CIF or REFFA funds. In these cases, the TA is compulsory as the purpose of the fund is to develop specific products that depend on the extra financing facility. The Investors have the opportunity to add a tremendous amount of value, and transmit their values to the investee. This is unusual for a debt investment, since debt providers do not have the possibility to be actively involved in the running of the company. The following covenant exposes how the TA facility is included in the TS, as well as its focus.

Besides the loan, *The Fund*, through its Technical Assistance Facility, will provide TA to the institution in order to support the education finance product implementation (e.g. intensive training of loan officers, marketing, careful design of loan products, etc.). A consulting firm, selected by The Fund, will carry out these TA measures.

Covenant 9: Technical Assistance Facility

4.8.2. *Implementation complexity*

The TA implementation process is not always clear to fund managers, especially when TA is required to attain the investment criteria for a specific mandate. The TS needs to be in line with the loan agreement, and the loan agreement needs to stipulate the investment objectives. Therefore, the TA needs to start alongside the investment. The sequencing of these events can however be challenging. In order to disburse the loan, TA is required for the investment to fit the mandate. On the other hand, the investment is required to disburse the TA facility. In the first case, the Impact Investor could face a situation where the TA is provided without being able to follow-up with the investment. Due to the grant nature of the facility, it would be difficult to call it from the investee, who would potentially already put it into use. In the second case, the TA could be blocked by the investment committee due to a misalignment with the mandate. Therefore, it is critical that the TS clearly articulates the sequencing and timeline of disbursement of both facilities. In general, the structuring is designed on a case by case basis. The following covenant illustrates both the timing of the loan in terms of its S&E objectives, as well as a clause linking the loan to the TA facility. The TA details would be included as an appendix, which can be easily included in follow-on investments or similar programs.

The borrower undertakes to develop its portfolio of loans to learners, their families and education providers. Unless the lender otherwise agrees in writing, the Borrower shall at all times comply with the following covenants relating to the program:

a) Use of the loan

The borrower shall use the Loan to finance the Program as follows:

Months after the date of the first disbursement	**Total Education Finance Outstanding portfolio of at least**
12	500m LCY
24	1.5b LCY
36	3b LCY
Months after the date of the first disbursement	**Total Education Finance Outstanding to parents of learners or learners of at least**
12	60m LCY
24	150m LCY
36	450m LCY

Within thirty (30) calendar days after expiration of each months as per the table above (12, 24, respectively 36), and after every twelve months, within thirty (30) calendar days, the Borrower will provide the Lender with a statement on the use of the Loan, including a confirmation that the Loan is used according to the provision. Such a statement shall be signed in original by the CEO and the CFO of the Borrower.

Technical assistance agreement

The Borrower shall comply with the terms and conditions of the technical assistance agreement.

Covenant 10: Example of Technical Assistance Requirements

4.8.3. BO case study - REFFA

BO is an interesting case study regarding TA. They have TA in three of their funds: REFFA, MIFA and CIF. For REFFA, the TA is intended to help develop education finance products.

The TA facility focus is mainly at the retail level, by establishing and developing educational finance products, and strengthening the processes around them. Education finance has three main target groups:

1. Education providers (schools), which is similar to SME lending with working capital needs;
2. The parents of the students, whether they are salaried workers or SME owners; and
3. Student loans, directly financing the student himself.

Some of the potential investees may already provide loans towards SME or consumer financing, which is indirectly used to support school fees. In terms of KYC, it is important to understand the use of the loan.

As an example, it is commonly recognised in Kenya that in December and January loans are used to finance school fees. However, these loans are not always tailored and marketed towards this purpose. This has two implications: first, the MFI lacks important information for its portfolio analysis, and second, the counterparty may have an inappropriate loan (timing and cost mismatch with the underlying use of funds). There is a certain moral hazard in deploying SME loans, which are used for school fees. Therefore, REFFA intends to address these issues in the best way possible.

For the MIFA fund, the TA use is broader, with the objective to strengthen processes in general such as underwriting, auditing, optimising the control structure. It is not necessarily focused on a particular product type. TA is appropriate for MIFA which focuses on tier 2 and tier 3 MFIs, which require more development than comparable tier 1 institutions.

Table 5: Microfinance tier definition

	Tier 1	Tier 2	Tier 3
Description	Mature, financially sustainable, and large MFIs that are highly transparent	Small or medium sized, slightly less mature MFIs that are, or are approaching, profitability	Start-up MFIs or small NGOs that are immature and unsustainable
Sustainability	1) Positive ROA for at least 2 of the 3 years; AND 2) No ROA <-5% in the last 3 years	1) Positive ROA for at least 1 of the last 3 years and other years >-5%; OR 2) Positive trend in ROA in last 2 years and >-5%	The rest
Size	> USD 50m	USD 5m - USD 50m	< USD 5m
Transparency	1) Regulated Financial institution; OR 2) Rated at least once in the last 2 years	Audited financial statements for at least the last 3 years	The rest

Source: Microrate Tier definitions, April 2013

The CIF fund is more similar to REFFA and is more product focussed. It helps develop climate insurance products for distribution. There is also a dimension of strengthening insurance companies or any companies in the value chain to better manage themselves, such as client education. Client education is crucial, as many do not understand the targeted product type.

4.9. Active ownership

Active ownership is a responsible investment approach that is particularly applicable to PE Impact Investing. Active (share) ownership is about exercising rights as a share owner. This can encourage companies to improve the management of risks in order to protect shareholder value and enhance long-term returns.

An interviewee took time to detail the fundamentals and relevance of governance, which is reflected hereafter. Company ownership is reflected in three levels of governance. First, you have the shareholders, who constitute the annual general meeting. Second, you have the Board of Directors, which represents the interests of all stakeholders. Finally, you have the company management. The shareholders will elect the Board of Directors. Governance best practices suggest that they should be independent from the shareholders, which is seldom the case. The interviewee estimates that in general, only 20% of a Board is independent. The Board of Directors elect the company's management. The consequence is that, instead of representing the interests of all stakeholders, the Board of Directors will mainly represent the shareholders' interests. The following covenant illustrates this structure.

The board of directors of the company ("the Board") shall be comprised of 5 directors, 2 of which will be appointed by the Manager, 2 appointed by the Investor and 1 independent director to be appointed by the investors in mutual agreement.

Covenant 11: Governance: Board of Directors

Through this governance structure, the Investor has the opportunity to transmit its values and the dual objective of financial and S&E returns. In many cases, the Director would be an investment professional from the fund manager. Due to lack of understanding of the local context, lack of seniority or in certain cases, lack of experience, the Investor would hire an independent Director. As a shareholder, the Investor will define the strategic plan for the company, such as product development or a targeted demographic group of customers. The strategy is in the form of a roadmap and guidelines for annual development. The strategy is submitted as a letter to the Board of Directors. The Chairman of the Board will thereafter communicate the directives to the other Directors, who will assess the feasibility and possibility to realise the shareholders' desires. Thereafter, the Board will work with management to implement an operational plan which includes a budget, resource requirement, IT requirements, etc. In turn, the plan is reviewed and approved by the Board and submitted to the shareholders for final approval. The covenant below highlights the level of control that the Investor can apply to the management company.

> Best practice on governance assumes written papers in advance, a schedule for board meetings and annual general meetings if there is a broad shareholder base. Board meetings will be held at lease quarterly. A board meeting and any meeting of the remuneration and ESG committees will not be quorate unless an Investor Director is present.

Covenant 12: Meetings

The Impact Investor has S&E objectives which can be incorporated into the company's operations, through appointment of a Director, reporting requirements and control over the work implemented by management. Governance is more powerful than S&E covenants within a contract, since the latter can only be defined *ex ante* the investment. An interviewee suggests that the shareholder can start creating significant value after 12 months as a shareholder.

The Investor may clearly articulate the investee's mission in the SHA. This explicitly details the region, the targeted demographics and the products and services. Usually, there is no particular reason for the company to have a mission drift. In the example below, the covenant illustrates the control of the investee on certain key strategic decisions, in this case linked to the Social Mission of the Company. It is a subject on which the Investor has a veto right.

> (…) Any material change in the nature and extent of the company's business and target market (the "Social Mission"), especially any deviation from its strategy to provide affordable healthcare to individuals with a monthly income lower than the minimum wage

Covenant 13: Affirmative vote rights

Although governance value-add is only attributable to equity investment, debt providers have the possibility to add significant value through TA. Although this instrument has been analysed in detail previously, it is important to highlight its relevance in providing certain guidelines to management. Although they are less constraining, TA is used as a tool that can be leveraged *ex post* the investment in order to incentivise changes within the portfolio company.

4.10. S&E Put option

Put options are usually used when investing in a smaller businesse with a higher risk profile. The use is further justified when it is difficult to foresee an exit opportunity. However, the investment still seems attractive to the Investor and a put option is included to increase the likelihood of exiting. The put option is valued upon entering into the investment, either as a book value multiple or a value that ensures a certain IRR.

A put option has two functions. First, it increases the likelihood for the Investor to be able to exit the investment. Second, the put option may act as a further guarantee that the S&E guidelines and objectives will be implemented. For example, the following covenant serves both objectives. In this case, the execution of the put option is highly probable, and both parties are aware of it. The design of the put option is based on the number of end users. The number of end users is an S&E target and a key revenue driver, since the underlying customer base contributing to revenues is composed of a certain demographic segment for which the product is designed. In this case, the put option is highly detailed and specific to the investment's financial and S&E objectives.

If a viable Exit opportunity does not occur, the fund would also have the right to exercise a put option to the investee. The put option would have the following elements:

- The put option is a legal obligation for the holding company to buy back all of the Investors shares in the portfolio company.
- Price for 100% investor share package with put option calculated on a per customer basis according to the following prices per customer for number of customers at point when put exercised:
  - Less than 20'000 customers – 100 dollars
  - 20'000 to 40'000 customers – 90 dollars
  - 40'000-70'000 customers – 30 dollars
  - Above 70'000 customers – 18 dollars
- If the Investor has sold part of his package before exercising the put option, price for remaining shares is proportional to original 100% share package. The investor can only exercise the put for the entire remaining shares held.
- Put can be exercised at any point from year five to year eight from the point of the investment closing or in case of an IPO or change of control at level of the investee
- The investor cannot transfer the put option to a third party buyer of its shares, but can transfer to the fund manager at any time
- The put price is capped at a maximum equivalent to 25% IRR to the Investor's initial contribution in equity. Included in this cap will be any dividends paid.

Covenant 14: Put Option Example

The following covenant, which is less detailed, is also a form of guarantee that there will not be a mission drift. As explored in section 4.5, this is a more radical protection from a mission drift.

> The fund shall be entitled to exercise the Put Option at any time after it becomes aware of the passing of a Shareholder's resolution in respect of a matter requiring a Special Majority (as may be required in terms of the Shareholder's agreement) but only in the event where such a resolution would, in the opinion of the fund manager, have the effect of changing the company's operations, strategic direction or commitment to improving the lives of low-income workers.

Covenant 15: Put Option enforcement

Finally, the following covenant is also less detailed and focuses on ESG default more broadly. In the researcher's opinion, the definition of an "ESG default" is vague and is probably intentionally left open to interpretation. The goal behind the covenant to likely be financially driven, as the definition is open to interpretation relating to ESG matters, whereas the exit date and exit value (predetermined IRR) are clearly articulated.

> In addition to the Investors' rights as set out in "Exit Strategy", the Promoter must purchase all the Investors' Shares on demand if:
>
> - There has been no Exit by 31st of December 2020;
> - The company defaults in any payment due to the Investors; or
> - There has been an ESG default.
>
> The price payable by the promoter shall be the amount necessary to deliver the Target IRR to the Investor, as agreed or determined by an independent expert.

Covenant 16: Put Option as an Exit Strategy

In practice, an interviewee insisted that it is quite rare that the counterparty would accept a put option. Despite being in line with the social objectives, a put option is putting a timeframe to attain certain goals and is based on a predetermined valuation. It also limits the investee's flexibility in designing and implementing new products, especially if the product is a trigger to execute the put option. For instance, if the investee realises that the product is targeting a population that is not economically viable or that they need more time, they do not have the possibility to redesign the product. Finally, a put option is an indication that the shareholder is not prepared to share the risk, and therefore goes against the desire to be in a partnership that is beneficial to all parties.

4.11. Endorsing programs

One of the methods used by fund managers to make reporting more homogenous in terms of data monitoring is to endorse industry programs. Recurring programs, such as the SMART Campaign, Client protection principles and reporting into the Mix Market platform are widespread, especially in microfinance. The following covenant binds the investee to report to the regulatory body as well as into the Mix Market[6] database. In addition, it requires that the investee endorsed the SMART campaign[7]. The interviewees indicated that this has not been a major concern when discussing terms, as many of the investees already endorsed these principles due to previous Investors.

The Borrower shall:

1. Ensure that it remains in line with consumer protection practices laid down by the Central Bank and other statutory bodies and ensure it is fully transparent in the pricing, terms and conditions of all financial products. The Borrower shall employ respectful collection practices and adopt high ethical standards in the treatment of clients.
2. Report financial and relevant social performance indicators to the Mix market on at least an annual basis. "Relevant" means that the MFI is not expected to report on all social indicators defined by the Mix Market but on the ones that are:
   a. Considered in line with its social mission
   b. Considered possible for the institution to provide given possible technological constraints linked to its MIS
3. Endorse the SMART Campaign on Client Protection Principles and implement the Principles within a reasonable timeframe
   a. The institution is expected to formally endorse the SMART Campaign by becoming a signatory online
   b. The institution is expected to conduct a self-assessment of its client protection practices within the first three months following the start of the debt partnership

Covenant 17: Program Endorsement

[6] MIX delivers data services, analysis, research and business information on the institutions that provide financial services to the world's poor.
[7] The Smart Campaign is a global effort to unite microfinance leaders around a common goal: institute client protection

4.12. Exclusion list

An exclusion list details activities in which the Investor cannot invest (negative screening). There are two types of exclusion lists: those that are designed internally by the Impact Investor, and those that are imposed by the LP (in most cases, a DFI). For the sake of simplicity, the fund manager's exclusion list will generally be based on an industry leader's list. In practice, this is the publicly available IFC exclusion list (available in appendix 8.1). The following covenant indirectly refers to an exclusion list, which is part of the fund manager's code of Responsible investing.

The Company must use the investment money: • To provide working capital, • In a manner consistent with the fund manager's social, environmental and governance requirements as set out in the code of Responsible investing.

Covenant 18: Exclusion List – Indirect covenants referring to its code of responsible investing

At the screening phase, the investment team will search for what is commonly called "red flags". These red flags are indications that the potential investee is not aligned to the Investors S&E requirements. Once the red flags are pointed out, a certain number of questions are asked: What resources are required to amend the issues? Can the issue be fixed? Is it on the exclusion list?

For example, CDC has aligned its exclusion list to the IFC's as part of its code of Responsible investing. This particular exclusion list is important for the industry, as the IFC leads many development finance transactions. The exclusion list is initially used as a screening tool. For example, CDC requires that the investees align themselves with IFC's performance standards, their exclusion list and local regulations within a reasonable period of time. If gaps are identified, an action plan is agreed upon. Potential investments are compared to the document. If the company operates in any activities included in the exclusion list, it has to be indicated. For CDC, this process is in line with their code of responsible investing.

Once the screening phase is complete and the investment teams receive the approval to do the on field DD, the exclusion list still remains relevant. Depending on the industry in which the investee operates, it is possible that it may be involved with a sector which is included on the exclusion list. Typically in Microfinance, this requires that the investment teams discuss the exclusion list and make clear that they cannot finance certain types of companies. As an example, when BO does the loan file reviews, part of the process is a cursory review of the exclusion list. Unfortunately, this does not guarantee that the investment is immune from certain excluded sectors. For example, some MFIs in India make $200 loans. In this case, the loan file review covers less than 10 basis points (0.1%) of the total files. It is challenging to screen out the excluded activities.

It is also important to take into account the regional context. For example, certain Asian regions are exporters of fireworks, a product excluded by many DFIs. This product is very important in the specific region as many professions depend on it. Although not directly financing the production, the MFIs lend to the infrastructure surrounding the activities.

An interviewee questioned the importance of an exclusion list for an Impact Investor. In his opinion, the importance is limited: for example, it is incoherent for an Investor doing development work to invest in illegal activities. The following covenant exposes how to articulate and include specific codes and exclusion lists into the TS.

ESG standards

The Group's business and that of the project company must be conducted in compliance with the Code, which includes:

- Compliance with international standards on environmental protection, including IFC Performance Standards;
- Compliance with international standards on labour and social matters, including the ILO core labour standards,
- Excluded activities (for example, illegal or banned chemicals, arms, gambling and pornography);
- Ensuring that the Group does not give or receive bribes or otherwise behave in a corrupt way; and
- The Group having appropriate levels of internal governance for a business of its size.

If DD identifies deficiencies in the Group's performance relative to the Code, the post-closing action plan will include proposals to achieve compliance within a reasonable period. A breach of the requirements of the Code after closing (which is material and is either not remedied or is capable of remedy is an ESG default.

The Investors may (at the Company's cost) appoint independent consultants to:

- Assess performance in relation to ESG matters in the action plan;
- Report on ESG breaches, allegations or complaints; and
- Periodically assess the Group's policies and practices on ESG matters.

The group must implement any recommendations of the consultants within a reasonable time, unless the Investors agree otherwise.

Covenant 19: Exclusion List Example

4.13. S&E management system (SEMS)

SEMSs are frameworks that the company has for the S&E performance management. The system has the objective of defining and monitoring the S&E goals of the institution, by looking at the mission statement and the overall strategy. This gives the implementer the freedom to tailor the program to specific company needs and requirements. It does not give a value judgement, for example if the company has a poverty reduction or a job creation focus. The main points are to have an articulated strategy, whether the strategy has a development angle and if it is clearly identified through target clientele selection. The goals must be achievable and must be measurable, with realistic indicators.

The Board, Management and employees need to be committed to these goals, with a realistic plan to attain them. In order to achieve the goals, supervisors and a committee should to be put into place. The following covenant highlights the roles and responsibilities of each party.

ESG Supervision

The ESG management system will be supervised by the Board or the named director or an approved ESG committee approved by the fund manager.

Supervision of the ESG management system shall involve:

- Oversight of implementation of the ESG aspects of the post-closing action plan;
- Examining ESG policies and procedures and their implementation and making recommendations for the improvement of the Board;
- Considering quarterly reports from management on implementation of the action plan;
- Reviewing and approving an annual report to the board and the Investors on ESG matters;
- Considering ESG assessment reports on new projects (and veto project/contract bids) where there is deemed to be a high risk of ESG issues; and
- Appointing consultants to investigate alleged breaches of alleged ESG policies and procedures in the Group.

Covenant 20: ESG Supervision

A clearly articulated monitoring process and assessment of each concerned individual performance to achieve these goals is necessary and defined with the Investor. Additional focus is put on the employee’s training and education with regards to the institutions S&E mission, with incentives and monitoring processes in-line with the objectives. As indicated by an interviewee, the SEMS is not a plug-and-play framework, mainly a system for setting and monitoring goals.

The following covenant shows how the SEMS can be included in the representations, which were previously discussed. In this case, the SEMS is considered exhaustive in focus. Any additional concerns should have been flagged beforehand and therefore the Investor is not liable for non-identified issues.

The Borrower represents and warranties that: a) To the best of the Borrower's knowledge and belief, after the inquiry, there are no material social or environmental risks or issues in respect of the Relevant Financing Operations other than those identified by the S&E Management System; b) The Borrower has not received nor is aware of: (i) any existing or threatened complaints, order, directive, claim, citation or notice from any Authority; or (ii) any material written communication from any Person concerning the failure by ay Client to undertake its operations and activities in accordance with the S&E Requirements; and c) Neither the Borrower, nor any affiliates of the Borrower, nor any person acting on its behalf, has committed or engaged in, with respect to its banking license or any transaction contemplated by the Agreement, any Sanctionable Practice, as defined in *Annex 7*.

Covenant 21: Representations

The following covenant includes the SEMS into the conditions precedent. By articulating the S&E management system as part of the conditions precedent, this gives the Investor comfort that the processes and focus of the S&E requirements are put into place as a condition to disburse the funds.

On or prior to the date of this agreement: a) The lender has received copies, in form and substance satisfactory to the Lender that so requests all of the insurance policies of the Borrower (and additional requirements to be determined by the Lender) b) The Borrower has delivered to the Lender the Social and Environmental Management System (SEMS) plan; c) The SEMS plan has not been amended, waived or otherwise restricted in scope or effect since *the 1st of January 2014;* d) The Borrower has designated in writing a senior officer of the Borrower, reasonably acceptable to the Lender, to be responsible for administration and oversight of SEMS (the "SEMS Officer")

Covenant 22: Conditions precedent

The following demonstrates how affirmative and negative covenants have different, yet complementary roles in enforcing the S&E management system. Affirmative covenants describe how to implement, enforce and adapt the plan in order to comply with the Investor's requirements.

> a) […]
>
> b) Undertake and implement the SEMS Plan in accordance with the requirements and schedule specified therein;
>
> c) Use all reasonable efforts to ensure the continuing operation of the S&E Management System to identify, assess and manage the social and environmental performance of the Relevant Financing Operations in compliance with the S&E Requirements; and in the event any successor or replacement SEMS Officer is appointed, ensure that such SEMS Officer shall be reasonably acceptable to the Lender;
>
> d) Without limiting any other right, remedy or claim of the Lender hereunder, if the Borrower becomes aware of any change in the scope of the Relevant Financing Operations, advise and consult with the Lender regarding any material social or environmental risk posed by such development and, if requested by the Lender or any shareholder of the Lender, amend the S&E Management System to identify, assess and manage such risks;
>
> e) if the Borrower becomes aware that any Client has undertaken Client Operations in a manner that is not in accordance with the S&E Requirements, it shall promptly: (i) agree with the relevant Client, or require the relevant Client to undertake, as appropriate or necessary in the Borrower's reasonable judgment, corrective measures to remedy such inconsistency or breach; and (ii) if the relevant Client does not implement corrective measures as provided in (i), use reasonable efforts to dispose of the Borrower's investment in such Client on commercially reasonable terms, taking into account liquidity, market constraints and fiduciary responsibilities.

Covenant 23: Affirmative Covenants

In addition to the guidelines provided by the affirmative covenants, the negative covenants restrict the investee from taking undesired actions, such as modifying the S&E management system without the Investor's prior consent.

From the date of this Agreement, the Borrower shall not:

a) Amend, waive the application of, or otherwise materially restrict the scope or effect of, the S&E Management System (including *[Option if SEMS Plan is not satisfactory at time of signing:* the SEMS Plan and] the S&E Requirements) without prior written consent of the Lender;
b) Provide sub-loans, financing or other financial support to any Clients engaged in any of the activities on the Exclusion List.

Covenant 24: Negative Covenants

The two covenants above are efficient in incorporating the SEMS into the contract. They have the scope to be legally binding, and are appropriately designed based on the stage of the investment.

4.14. Action Plan

An action plan, also referred to as a "roadmap", is a detailed guideline on processes to implement in order to attain S&E objectives. CDC defines the action plan as *"an environmental, social and governance action plan in the agreed form defining actions, responsibilities, budgets, deliverables, compliance, indicators, and a timeframe for the measures required to remedy any known non-compliances with the ESG requirements in the business activities of the company, including the establishment of an appropriate ESG management system, as may be amended with the approval of the Investors from time to time"*. The following covenant introduces the Action Plan into the TS.

The parties will agree on an action plan to be implemented after closing which features key action points arising from the DD, with corresponding milestones, target dates, costing budgets and management responsibilities. The Company will implement this plan in accordance with its terms and present regular reviews of progress to the Investors. The action plan will incorporate ESG matters.

Covenant 25: Action Plan

The following covenant is complementary to the previous, as it shows that the Action plan can also be included as a condition precedent. Typically, a CP is an agreement on the Action

Plan, without necessarily implementing all the actions: some of the actions included in the Action Plan will not be CPs.

Conditions to signing The signing of legal agreements is conditional upon: • Conclusion of DD, including financial, commercial, legal and ESG and agreement of the Action Plan;

Covenant 26: Conditions to Signing

Although it could in theory be applicable to equity and debt investments, the research only found cases where it was included in equity investments. The researcher assumes that the main reason for this is divergence in timing. Equity Investors have a timeframe in which they operate; however there is no fixed date of exit. On the other hand, a loan has a finite life, and the repayment is contractually agreed.

The Impact Investor would determine with the head of social performance and the head of management what inputs and activities need to be put into place in order to generate outputs that are in line with the Investor's values. However, the focus is placed on the process, not the outputs.

In the following table, the action plan is used as a condition precedent to capital disbursement. There is alignment between the execution of the action plan and the capital deployment.

The investment in the company will be staged as follows: • $X M at Closing; • $X M in $10 m tranches, within 18 months of closing, conditional on achieving pre-agreed milestones, including those set out in the action plan referred to below.

Covenant 27: Timing of the Investment

The action plan is used in certain instances as a reporting and monitoring tool, and is complimentary to the SEMS. These metrics are usually used to measure progress as opposed to a target. This allows the Investor to monitor the progress over time and the appropriate use of capital. Focussing on the process also gives the Investor a certain level of flexibility, which takes into account changes in the market, the client base and the product offering. This allows the managers to be opportunistic and implement the best possible strategies without to many restrictions.

4.15. Convertible debt

Following the previous section on the action plan, an additional security around the action plan can be implemented by using convertible debt. Convertible debt is based on a schedule and conditions which allow the Investor to make sure that the capital is being used according to his plan.

Upon completion of the schedule, the loan would be converted into equity at an equivalent value. The value of the company may also vary depending on the achievement of certain goals (not necessarily S&E). For example, certain conditions may include a change in management, appointment of a social committee, target a specific demographic segment, or develop additional products. The latter is illustrated in the following covenant, which details the timeline to follow in order to secure the equity investment.

> The investee hereby expressly and irrevocably commits that, within a term not to exceed 1 (one) year after the Closing Date, it will dedicate at least 10% (ten percent) of its portfolio to the level D economic group and 15% (fifteen percent) within a term not to exceed 2 (two) years as of the closing date. The operational plan containing these obligations shall be presented for approval to the board of directors and will include the specific metrics it will track.
>
> Upon completion, the loan will be converted into common shares based on a roll-forwards valuation.

Covenant 28: Convertible Debt Timeline

4.16. Events of default

The following segments will look into the enforcement of the agreed upon terms, the relevance and some examples.

4.16.1. Breaching the exclusion list

Breaches of the exclusion list can occur *ex ante* or *ex post* the disbursement. If the breach happens *ex ante*, the investment team has three solutions. First of all, they can simply screen the investment out. This will avoid any complications and potential reputational risks. Secondly, if the investment offers financial and S&E returns that are in line with the Investors objectives, the deal can still take place if the prospective investee makes internal changes. This can either be by limiting future activities with excluded sectors or by eliminating those that are already active. This would occur after a conversation with the management team. If eliminating activities with a particular industry is not possible, there is the possibility to amend the TS and legal documentation. Although fund managers try to avoid modifications as much as possible to remain efficient and consistent, it is a possibility. For a proprietary fund (for example, the BOMF, BFOF or the BFIF), modifications are less complex and require the approval of internal authorities. However, for mandates, this could require a third party approval.

Following the interviewee's example illustrated in a previous section of the investment in the MFI that finances the fireworks infrastructure, the case was presented to an external investment committee. This external committee has three representatives from three DFIs. For each deal made with the managed fund, the investment proposal must be presented to both the internal investment committee and the external investment committee. Investment committees are practitioners and understand the workings of particular businesses, whereas exclusion lists are political. This configuration makes the investment process longer; however, it allows more flexibility. In the fireworks case, the external IC accepted the modifications to the exclusion list and waived the clause on fireworks.

If the breach happens *ex post* the capital disbursement, the situation is more complex. In theory, the Investor could notify the portfolio company and put them into default. This then facilitates the ability of the Investor to execute the appropriate clause (accelerate the loan or call the investment). In practice, none of the interviewees have been in this situation.

4.16.2. Breaching the TA agreement

Investors providing TA try to make the contract as legally binding as possible. The loan agreement is generally tied to the TS, which includes all operational covenants. In case the investee does not comply, the Investor has the power to accelerate the loan. This is more complicated when the loan is subordinated debt. In this case, there is usually not the possibility to accelerate the loan. However, the contract may include a default rate. This allows the Investor to require a higher interest rate in case of covenant breaches. If the rate is high enough, the loan will no longer be competitive and the investee would want to raise alternative financing. Certain regulations prohibit loans from being prepaid, indicated an interviewee.

It is important to assess the relevance of accelerating a loan due to breach of TA. By definition, TA is a grant that intends to catalyse change within the portfolio company, in line with the fund's objective. The question may be asked whether this "bonus" financing facility is a basis for events of default. The answer to this depends on the use of the purpose of the TA facility.

REFFA, a fund that provides TA, has the mandate to develop educational products. The TA facility broadens the range of financial instructions in which it can invest, since it can *inter alia* subsidise product development. However, it has the obligation to invest in entities that have this specific product. If the institution does not develop the education finance offerings, the financial institution will no longer be aligned with the objectives of the fund. If they are not willing to develop the required products, they are not eligible for the loan. This is a sufficient reason to trigger an event of default. The same principle is applicable to the CIF fund, which specifically has the mandate to develop climate insurance products.

In the case of MIFA, the TA is a facility used to make internal improvements, such as process developments and implementations of best practices. Consultants would conduct a review, produce a report and recommend steps to follow. Since the TA has more of a benefit to the investee, it is at their discretion whether or not to implement the changes. This supports the cost sharing structure, which will incentivise the company to not "waste" their expenditure. However, this is not in the researcher's opinion a sufficient reason to accelerate the loan.

4.16.3. Principle of proportionality

The principle of proportionality is not a term that was used by the interviewees; however it describes a recurring theme that was talked about. When investing with the focus on Impact, certain breaches of strict covenants need to be assessed relative to the "bigger picture". To use the exact words, it's about "balancing the pros and cons". An example used was that of bribes. All the fund managers, without exception, condemn such practices. However, they are fully aware that in certain countries, this practice is part of "business as usual". Despite explicitly forbidding bribes, they are often beyond the control of the Investor. If the practice is recurrent and no action is taken by management to reduce it, this would lead to an event of default and the Investor could call the loan. However, when compared to the Impact the company is having on broader communities' livelihoods, the practice does not justify terminating the investment relationship.

4.16.4. Calling the investment (equity)

Calling an investment would only be used as a last resort for an equity Investor. The tools that can be used to enforce such an action have been detailed previously (e.g. the put option). In reality, except for a predefined exit, calling an investment is both expensive and time consuming. First of all, the Investor is confronted with the valuation and price at which he would recuperate his capital. Secondly, he needs to make sure that the counterparty is able to pay a price which at least returns the invested capital. Finally, exiting an investment terminates all governance roles within the firm, which is contrary to the role of the Investor in contributing to creating value. Among all the interviewees, not one had ever had to take such action.

4.16.5. Accelerating the loan (debt)

In case of a breach of covenants, the Investor has three choices. First, the breach can be temporarily waived, leaving sufficient time to the investee to correct it. Second, the Investor could amend the loan agreement. By doing this, the investee will no longer be in a breach of covenants. Finally, and only in extreme cases, the Investor can accelerate the loan

Put into perspective, accelerating a loan is not always optimal from both a financial and S&E point of view. First, an average loan provided by an Impact Investor would usually be in the range of 2-3 years. If the client happens to be in an event of default due to a covenant breach, the likelihood of accelerating the loan is low. Second, there are extensive upfront costs (mobilised internal and external resources, DD, advisory, and so on) prior to the investment that need to be amortised. Unless there is a severe breach of covenants, it will be difficult to justify the loan acceleration. Finally, in the case of a breach of S&E covenants, the breach must be analysed relative to the actual Impact of the use of the capital. For example, if certain S&E targets are not quite met, such as number of jobs created, the breach must not only be put in perspective with the overall achievements of the investee but also with the costs incurred by the investee of doing so.

5. CONCLUSION

5.1. Results

Despite the fact that this research was designed to compile a guide to best practices in Impact Investing term sheets, the foundation of the analysis rests on the testing of two distinct hypotheses.

5.1.1. Hypothesis 1 (null): Impact Investors do not align the TSs to their values.

The first hypothesis tested whether or not Impact Investors have an alignment between their values and the content in their TSs. The researcher stated, *ex ante*, that the Impact Investor should have systematic alignment between the values, the public statement and the requirements from the portfolio companies.

The conclusion to this statement is that the null hypothesis cannot be rejected.

First, the analysis pointed out that, within the narrow definition, the term sheet is a non-binding document. As such, it is kept as efficient and succinct as possible. Since it is provided at an early stage, it depends on elements such as DD and conditions precedent. Depending on the target company, the focus of the S&E impact differs vastly.

Second, term sheets are not identical among different Investors. DFIs have the highest alignment between their targeted S&E returns and their term sheets. Without exception, all of the templates provided by the DFI took a strong position regarding S&E covenants. This was reflected through the exclusion lists, the action plan, the SEMS and the governance structure. The conclusion on the reason why DFIs are particularly bound to impact is due to their political nature and business model. There is opportunity to pursue investments that have a lower cost of capital, which is facilitated by the mandate. Since the capital deployed is constantly reinvested, there are less stringent requirements from the Investors. Historically, DFIs have a stronger role in development than Impact Investors. Due to the fact that only templates were provided, there is not sufficient evidence from investments that executed term sheets reflect the DFI's values and the researcher cannot therefore reject the null hypothesis. In comparison, the commercial fund managers showed in both cases that the term sheets remained highly consistent from one investment to another. This is based on efficiency and cost saving policies. However, case by case analysis has shown that certain documents are aligned with the Investor's values. For example, certain TSs contained the TA facility explicitly in the conditions to invest. Others protected their values through put options.

Third, the term sheets are not identical throughout different asset classes. There were significant discrepancies between equity and debt term sheets. On one hand, equity investments had a much stronger focus on governance. Through this, the values were de facto put into the investment structure. However, the S&E goals were not always explicitly laid out and did not give sufficient arguments to reject the null hypothesis. On the other hand, debt Investors expressed the importance of integrating S&E covenants in the TS; this was not confirmed during the document screening. The main point here is that loan covenants have to be flexible enough to accommodate changes that occur during a business' lifetime. Including fixed targets would be a burden, as it would hinder the management from making objective and appropriate strategic decisions.

Finally, the fund strategy is considered by most LP as being sufficient to be aligned with the Investors' values. In both cases, the equity and the debt providers invest into companies that are in line with their mandate. Most of the time, this is sufficient to generate positive S&E returns, alongside financial returns. With regard to these legal issues, and when talking about the values and S&E Impact, the parties sign the agreements because they already know that they have matching goals. In many cases, this is more relevant than trying to push clients into making changes.

5.1.2. Hypothesis 2 (null): Impact Investors do not require that certain clauses be systematically included in order to protect their interests.

The second hypothesis was linked to the first as a follow-on research question. Indeed, systematic inclusion of certain clauses throughout the term sheets would require that they reflect the Investor's values. Therefore, it is not possible to reject this hypothesis.

This hypothesis was more subtle as the first, as it tests the recurrence of individual themes throughout different term sheets, as opposed to a general representation of values.

One of the key reasons for the inconsistency is that S&E objectives are determined on a case by case basis. With financial covenants, it is easier to have a benchmark target (PaR, Debt Service coverage ratio, ROE, ROA, etc.), since finance has more of a homogeneous requirement from one investment to another. With regards to S&E objectives, the targets and processes vary from one industry to another. For example, energy investments would aim to increase the access to energy for a specific region, agriculture investments would target increased productivity and gender equality, microfinance would aim to increase the total loan portfolio size, etc.

Furthermore, there is variation between different industries. As an example, microfinance investments have different targets depending on the product type: climate insurance products have a different S&E Impact profile than Education loans. Furthermore, they have different S&E impact profiles depending on the type of institution, since tier 1 institutions cannot easily be compared to tier 3 institutions.

One item, which was present throughout the reviewed term sheets, is the exclusion list. Although it was not always the same (both inter fund and intra fund), it was a recurring element.

In conclusion, there is not enough evidence to reject the null hypothesis.

5.2. Key challenges

The initial focus intended to develop a best practice guide based on term sheets in the narrowly defined sense. Having received and reviewed real legal documents, the focus was quickly redirected to legal documentation in the broader definition. This is due to the fact that a term sheet is part of a process, and the key information can only be captured when analysed in its entirety. Although this was initially a concern for the researcher, comfort was gained due to the exploratory objective of the research.

The documentation received and reviewed was extensive. Thanks to the focus of the study, the pinpointing and development of key elements was facilitated. However, the information extracted throughout the research is part of a large set of information and covenants. In some cases, it is difficult to extract relevant information without getting lost in unnecessary detail. There was significant variance between each document, based on asset class, Investor type, industry focus, etc. This made it difficult to compare each covenant on an equal basis, but increased the research's application and relevance independently of the deal's characteristics.

6. RECOMMENDATIONS FOR FURTHER RESEARCH

The researcher would recommend that further research be conducted in the following manner.

First and foremost, the researcher would recommend focusing future research on the contractual agreements between the LP and the GP. After having analysed the different terms sheets, the lack of systematically included covenants within the same fund mandate indicates that there may be a misalignment or lack of clarity between the goals of the LP and the GP.

Second, the researcher recommends to narrow down the scope to a specific industry, or group of similar ones. The same methodology could be applied to an industry in isolation. This would allow the researcher to extract best practices that are relevant and focussed. The microfinance sector has been the most explored, despite the scarcity of information on legal aspects. Although the interest varies on a personal level, the researcher would recommend starting with the agriculture sector, as it is gaining increased traction from international Investors and concerns a significant portion of the African population. Furthermore, an interesting sector to explore would be infrastructure, as it is often based on a PPPs. This would highlight the key requirements from a governmental perspective, and usually would involve larger sized investments.

Third, the researcher recommends future research to limit the scope to a specific asset class. The researcher recommends an initial focus on PE, as it has more complex characteristics. For instance, it would be particularly insightful to compare fund managers on their governance best practices. This could focus on the implementation of the action plan, how processes are designed and implemented, which monitoring metrics are most relevant and how Investors are enforcing proprietary measurement frameworks.

Fourth, future research could compare performance between funds that have more or less constraining S&E covenants. Performance was intentionally left out of the research, as it takes a far more quantitative approach than the methodology used here. As a follow-on research, the link between the constraint in legal documents and the overall financial performance would be highly insightful to practitioners and the academic community. Although less obvious, it would also be interesting to see if highly binding documents to S&E targets have a positive marginal effect on the S&E performance.

Finally, the interesting future research should focus on DFIs in isolation. Since DFIs have the strongest S&E agenda, it would be important to compare similar institutions with one another. Although the researcher anticipates that there will be strong resemblance due to the dominant position of the IFC, it would be valuable to gain insight into the best practices and which institutions are innovating the investment structuring to accommodate less developed companies in difficult regions.

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8. APPENDICES

8.1. IFC Exclusion List

NOTE: This Exclusion List relates to IFC's investments prior to IFC's introduction of the Environmental and Social Review Procedure version 2 dated July 30, 2007. The IFC Exclusion List defines the types of projects that IFC does not finance.

IFC does not finance the following projects:

- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in weapons and munitions[i]
- Production or trade in alcoholic beverages (excluding beer and wine).[i]
- Production or trade in tobacco.[i]
- Gambling, casinos and equivalent enterprises.[i]
- Trade in wildlife or wildlife products regulated under CITES.[ii]
- Production or trade in radioactive materials.[iii]
- Production or trade in or use of unbonded asbestos fibers.[iv]
- Purchase of logging equipment for use in primary tropical moist forest.
- Production or trade in pharmaceuticals subject to international phase outs or bans.
- Production or trade in pesticides/herbicides subject to international phase outs or bans.
- Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.

A reasonableness test will be applied when the activities of the project company would have a significant development Impact but circumstances in the country require adjustment to the Exclusion List. All financial intermediaries (FIs), except those engaged in activities specified below*, must apply the following exclusions, in addition to IFC's Exclusion List:

- Production or activities involving harmful or exploitative forms of forced labor[v]/harmful child labor.[vi]
- Commercial logging operations for use in primary tropical moist forest.
- Production or trade in products containing PCBs.[vii]
- Production or trade in ozone depleting substances subject to international phase out.[viii]

* When investing in microfinance activities, FIs will apply the following items in addition to the IFC Exclusion List:

- Production or activities involving harmful or exploitative forms of forced labor[v]/harmful child labor.[vi]
- Commercial logging operations for use in primary tropical moist forest.
- Production or trade in products containing PCBs.[vii]
- Production or trade in ozone depleting substances subject to international phase out.[viii]
- Production or trade in wood or other forestry products from unmanaged forests.
- Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial scale usage of hazardous chemicals.[ix]
- Production or activities that impinge on the lands owned, or claimed under adjudication, by Indigenous Peoples, without full documented consent of such peoples.

*When engaged in trade finance, given the nature of the transactions, FIs will apply the following Exclusion List:

- Production or activities involving harmful or exploitative forms of forced labor[v]/harmful child labor.[vi]
- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in weapons and munitions.[i]
- Production or trade in alcoholic beverages (excluding beer and wine).[i]
- Production or trade in tobacco.[i]
- Gambling, casinos and equivalent enterprises.[i]
- Trade in wildlife or wildlife products regulated under CITES.[ii]
- Production or trade in radioactive materials.[iii]
- Production or trade in or use of unbonded asbestos fibers.[iv]
- Commercial logging operations or the purchase of logging equipment for use in primary tropical moist forest.
- Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.
- Production or trade in products containing PCBs.[vii]

Footnotes

i. This does not apply to project sponsors who are not substantially involved in these activities. "Not substantially involved" means that the activity concerned is ancillary to a project sponsor's primary operations.
ii. CITES: Convention on International Trade in Endangered Species of Wild Fauna and Flora. A list of CITES listed species is available from the Environment Division.
iii. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.
iv. This does not apply to the purchase and use of bonded asbestos cement sheeting where the asbestos content is less than 20%.
v. Forced labor means all work or service, not voluntarily performed, that is extracted from an individual under threat of force or penalty.
vi. Harmful child labor means the employment of children that is economically exploitive, or is likely to be hazardous to, or to interfere with, the child's education, or to be harmful to the child's health, or physical, mental, spiritual, moral, or social development.
vii. PCBs: Polychlorinated biphenyls - a group of highly toxic chemicals. PCBs are likely to be found in oil-filled electrical transformers, capacitors and switchgear dating from 1950-1985.
viii. Ozone Depleting Substances (ODSs): Chemical compounds which react with and deplete stratospheric ozone, resulting in the widely publicised 'ozone holes'. The Montreal Protocol lists ODSs and their target reduction and phase out dates. A list of the chemical compounds regulated by the Montreal Protocol, which includes aerosols, refrigerants, foam blowing agents, solvents, and fire protection agents, together with details of signatory countries and phase out target dates, is available from the Environment Division.
ix. A list of hazardous chemicals is available form the Environment Division. Hazardous chemicals include gasoline, kerosene and other petroleum products.

8.2. Fictitious Loan TS

Borrower	PowerAfrica Ltd
Lender	Blooming Africa Fund S.A., SICAV-SIF. Vehicles managed by Impact Partners LLC
Financing Facility	A Senior Loan financing facility in an aggregate Principal Amount of $50,000,000.
Contractual Currency	United States of America Dollars (USD0)
Principal Amount	$50,000,000
Purpose	The proceeds from the Financing Facility will be used to finance the acquisition of a hydroelectric power generator in Mombasa, Kenya
Conditions Precedent to Execution of Financing Facility Agreement	The execution of the Financing Facility Agreement ("the Agreement") is subject to the satisfaction of the following conditions: 1. Such authorisations, approvals and consents as required by the Borrower's current investors and lenders. 2. Completion of an operational, financial, and legal DD on the Company to the satisfaction of the Lender. 3. Approval by the Lender's Investment Committee. 4. Negotiation and agreement on all terms and conditions as set out in the Agreement by both the Lender and Borrower.
Conditions Precedent to Disbursement	1. Execution of the Agreement by both the Lender and the Borrower. 2. Receipt of all required authorisations, approvals and consents. 3. The absence of material adverse changes with respect to the Borrower, its business, or future business prospects.
Target Closing Date	15th January 2016
Closing Fee	The closing fee is 0.5% of the Principal Amount, payable at the Closing Date.

Disbursement Date	31st January 2016
Maturity Date	3 years after Closing Date, on the 15th January 2019.
Principal Outstanding	The disbursed and unpaid amount on the Financing Facility.
Amortisation	No amortisation will be applied on the Principal amount
Security	The Financing Facility will be secured by the following up to the outstanding principal balance of the loan and expected Cash Interest and Bullet Interest Payments, to be furthered defined following DD: • A security interest in all accounts receivable of the Borrower arising from the sale of inventory (and other goods and services), cash and deposit accounts; • A security interest in substantially all other property of the Borrower, including, without limitation, contracts, patents, copyrights, trade-marks, owned real property and intangibles.
Bullet Interest Rate	• The bullet interest rate is **9.0% per annum.** • The Bullet Interest Rate accrues per annum, shall be computed on the Principal Outstanding, on an Actual/360 basis and is payable at the Maturity Date. • Such interest shall be free and clear of any taxes to the Lender. • At the Maturity Date the bullet interest payment is due, if the Interest Payment is not made in full then the Default Rate starts to accrue.
Interest Payment Dates	Bullet interest repayment on the 15th January 2019.
Default Rate	The Borrower agrees to pay automatically and without any prior notice from the Lender, from the date of the Event of Default under this Agreement, an additional interest of 3% per month added to the regular interest rate, without prejudice to all legal actions brought by the Lender against the Borrower.
Repayment	The Borrower shall repay to the Lender any outstanding amount of the Loan on the Maturity Date.

Prepayments	• The Borrower is not entitled to prepay any sum due under this Financing Facility unless the Lender expressly agrees thereto in writing. In such event, the Borrower does not incur any penalty thereby. Prepayment shall be made together with the accrued interest thereon and on any sum paid in purported prepayment shall be applied first in payment of all accrued interest and thereafter towards repayment of the Loan, in part or in all.
Payments	• Any payment under the Financing Facility shall be made in the Contractual Currency (USD) unless the Lender expressly agrees otherwise in writing. • Any payment made by the Borrower shall be made on a Business Day, in the Grand Duchy of Luxembourg.
Events of Default	Events of Default, customary to similar transaction, including: • Breach of Affirmative, Negative, Financial and Social Covenants. • The Borrower fails to pay in full when due any sum which shall have become due at the time and in the manner specified herein; or • Any representation, warranty or statement made or given by the Borrower in or in connection with the Financing Facility, shall be or become incorrect or inaccurate in any material respect at the time given, or at any time thereafter whilst any part of the Financing Facility remains outstanding; or • The Borrower fails to perform or observe any material provision of the Agreement (other than a payment on time) and such failure, if capable of remedy shall continue for Fifteen (15) Business Days after the Lender shall have given to the Borrower notice of such failure; or • The Borrower is dissolved (other than a dissolution for the purpose of reconstruction or reorganisation under which the successor entity, assuming the Borrower's functions and assets, undertakes with the approval of the Lender to be

	bound to carry out in full the provisions of the Agreement) or is wound up or has a receiver appointed over any part of its assets or proceedings are commenced by or against the Borrower for a readjustment or re-arrangement of its debts, or any action is taken by the Borrower or any event occurs which shall have an equivalent effect; or • Any lawful Governmental or other consent or authority, required to make the Agreement legal, valid, binding and enforceable, is withdrawn or ceases to be in full force or effect; or • The Borrower suspends or threatens to suspend its operations or ceases acting substantially in its current capacity (provided that the provisions of this clause will not be triggered by a decision of the Borrower's Board to suspend, curtail or close operations in any one or more territory/ies due to the commercial viability or strategic relevance of such territory/ies), or there is a transfer or disposal of all or a substantial part of the Borrower's assets (whether by one or more transactions, related or not) unless the body to which the Borrower's functions, duties or assets are transferred, for the purposes of reconstruction or reorganisation, undertakes with the approval of the Lender to become bound to carry out in full the provisions of the Agreement; or • There is a material adverse change in the business, assets or financial condition of the Borrower, which change of circumstances gives reasonable grounds to conclude, in the opinion of an auditor agreed by the parties (or, failing agreement, appointed by an independent party), that the Borrower will not, or will be unable to, perform or observe its obligations under the Loan Agreement; or • The Borrower is insolvent or unable to pay its debts as they mature or the Borrower's application for, or consent of, the appointment of a trustee or receiver for any of its property, or

	any bankruptcy, reorganisation, debt arrangement or other proceeding under any bankruptcy or insolvency law instituted by or against the Borrower; or • The Borrower contracts any additional debt without prior written approval from Lender; or • Cross default: Any other material (definition to be agreed) indebtedness of the Borrower which shall become due and payable or capable of being declared due and payable prior to its stated maturity, or the Borrower is in breach of or default under any agreement, deed or instrument under or pursuant to which such indebtedness was incurred; or • Change of Control: The majority shareholders dispose, or take any action towards the disposal, of their shares in the Borrower.
Representations and Warranties	Customary representations and warranties in similar transactions, including that the Lender: • Is a properly constituted company incorporated; • Has power to enter into the proposed Agreement, to borrow the Financing Facility and to perform its obligations under the Agreement, and has taken all necessary corporate actions required to authorise the execution, delivery and performance of the Agreement and the borrowings to be made hereunder; • All consents, approvals, registrations or authorisations required to enable the Borrower lawfully to enter into the Agreement and perform its rights and obligations hereunder have been obtained or made and are in full force and effect; • The Agreement will constitute a legally valid, binding and unconditional general obligations of the Borrower enforceable against it in accordance with the terms hereof; • The Borrower has not failed in its material obligations and there has been no material effect on its financial position or assets resulting from any failure of the Borrower to perform

	its obligations under any agreement to which it is a party; • No litigation or administrative proceedings before or of any Court or Governmental authority is pending or to the knowledge of the Borrower threatened against it or its assets which might have a material adverse effect on the business assets or financial conditions of the Borrower or its ability to perform its obligations hereunder; • Save as provided by any applicable laws of winding-up, liquidation or receivership or similar laws of general application, the obligation of the Borrower under the Agreement will rank senior, in respect of priority of payment and security, with all other indebtedness of the Borrower; • No written statement furnished by the Borrower contains or will contain any untrue statement of a material fact or omits to state a material fact necessary to make the statements not misleading.
Affirmative Covenants	4. Within thirty (30) days after the end of each month, commencing with the period ending on or about January 31st 2016, the Borrower undertakes to submit standard monthly reports to the Lender which include key indicators of the financial soundness of the business and social Impact; 5. Within one hundred and eighty (180) days after the end of each fiscal year the Borrower undertakes to supply the Lender with copies of its audited annual accounts including balance sheets, revenue and expenditure accounts, and its published annual report. 6. Within thirty (30) days after the end of each calendar year, commencing with the period ending on or about December 31st 2015, the Borrower's annual budget for the then current fiscal year. 7. Notwithstanding the above, the Borrower accepts to procure automatically to the Lender any information on the financial

	(including sources and uses of cash), operation and institutional positions of the Borrower, as may be further determined from time to time by the Lender. 8. The Borrower undertakes that it will obtain promptly, and maintain in force, all registrations, licenses and approvals as may be required to enable it to perform its business and its obligations hereunder. 9. The Borrower undertakes promptly to notify the Lender in writing of any Event of Default or any event which, with the giving of notice lapse of time or both, might constitute an Event of Default or adversely affect the Borrower's business or jeopardise the repayment of the Loan, interest or other monies due under the Agreement. The Borrower declares and confirms its acknowledgement and acceptance of all statements and records of the Lender as conclusive evidence of the indebtedness of the Borrower in a Court of Law/ Arbitration Tribunal AND the Borrower shall if so required by the Lender from time to time provide and deliver to the Lender promissory notes as further evidence of indebtedness for payment to the Lender of all or any part of the Loan without prejudice to any other right of the Lender whether accrued or due to accrue under the Loan Agreement. 10. The Borrower agrees to allow the Lender an agreed scope of use of their logo, pictures and non-confidential company information for marketing purposes which supports the mission of the organization.
Negative Covenants	1. Limitations on asset dispositions, in particular the sale or disposition of assets not otherwise expressly permitted to be disposed of or sold, so long as the assets sold or disposed of do not exceed, as of any date in any fiscal year, an amount equal to 10% of the consolidated tangible assets of the Borrower. 2. Limitations on mergers, liquidations, consolidations,

	dissolutions and other fundamental changes. 3. Limitations on cash dividends, redemptions and repurchases with respect to capital stock. 4. Limitations on debt and guarantees. 5. Limitations on loans, investments and acquisitions. 6. Limitations on liens. 7. Limitations on transactions with affiliates on less than arms' length terms. 8. Limitations on cancellation of debt and prepayments, redemptions and repurchases of debt. 9. Limitations on changes in business. 10. Limitations on changes in accounting treatment and reporting practices or the fiscal year. 11. Limitations on amendment of constitutive documents and other material agreements to be agreed, except for modifications that could not reasonably be expected to materially and adversely affect the interests of the Lenders.
Financial Covenants	• Minimum interest coverage ratios, calculated as EBITDA to Interest expense, is no less than 2x, starting one quarter from the disbursement of the loan • Max debt to equity ratio: 4x (less clients funds) • Ending closing cash balance is no less than $1,000,000 at all times • 90 days portfolio at risk to gross working capital portfolio is no larger than 5% • On the last day of each calendar quarter, the actual sales to budgeted sales ratio is no less than 50% • Further covenants might be defined pending DD.
Social Covenants	• The borrower (and its subsidiaries) shall not change in any material way the goals of its operations substantially conforming to the projections delivered to the Lender prior to the date hereof. For the sake of clarity, the goals of the Borrower are to enable access to affordable and reliable

	energy in previously electrified regions in Eastern Kenya and Northern Tanzania, while remaining carbon neutral. Determination of what constitutes a material change in the goals of the operations of Borrower shall be at the reasonable discretion of the Board of Directors. • The borrowers goals to be reached by December 31st 2018 are • Increasing energy supply by 10% yoy • Enable access to energy to 200,000 additional households • Maintain an 80% power reliability (average over 3 years)
Seniority	The Bullet Interest and Principal Amount should be *pari passu* to current Senior loans undertaken by the institution.
Assignment	The Lender may assign its rights under the Loan Agreement by endorsement, as further provided for by applicable law. The Borrower may not assign a right or obligation it may have under the Loan Agreement, unless the Lender expressly agrees thereto in writing.
Expenses & Taxes	The Borrower agrees to pay all charges and expenses incurred by the Lender in connection with: • The agreed and reasonable legal and other fees in relation to the drafting and conclusion of the loan agreement subject to the proviso that the loan agreement is concluded and the first tranche loan funds are advanced to the Borrower. The parties record that the foregoing provision will not be applicable if the Borrower terminates negotiations. • Any collection or enforcement proceedings and all legal fees and registration fees.
Change of Circumstances	Should any of the provision of the Agreement be rendered invalid, in whole or in part, by any change in applicable laws or regulations, or be declared invalid by order, decree, or judgment of a court or governmental agency of competent jurisdiction, the remaining provisions of this agreement shall not be affected thereby, and this agreement shall be construed as if such invalid provisions had not

	been inserted in this agreement or as if the new law or regulations were incorporated therein.
Confidentiality	All Parties hereto shall keep all negotiations confidential and maintain the contents of this Term Sheet in strictest confidence and shall make no announcement or disclosure without the prior written approval of the other Party save in respect of disclosures or announcements which may be required by any law or regulation, and any disclosures to each Party's consultants, advisors, employees/Directors (or by the Investors to its affiliates or their employees/ Directors/ advisors/ consultants) on a need-to-know basis.
Exclusivity	The Company agrees that following 30 days from whichever comes later, the 15th of January 2016 or the execution of this Term Sheet, they shall suspend all other existing enquiries with potential lenders and also not directly or indirectly (through their affiliates or their advisors, etc.) pursue, explore, solicit or otherwise seek alternative forms or sources of debt, equity or equity-equivalent capital for the Company, nor explore transactions involving the sale, transfer or encumbrance of the shares or business or undertakings of the Company.
Amendment	The Parties may amend the terms of the Agreement by mutual consent in writing.
Governing Law	The provisions of the Loan Agreement shall be governed and construed according to the laws of the **Grand Duchy of Luxembourg**
Arbitration	Any dispute arising out of or in connection with this contract including any questions regarding its existence, validity or termination, shall be referred to and finally resolved by arbitration under the London Court of International Arbitration (LCIA) Rules.
Legally Binding Understanding	It is hereby expressly agreed between the Parties that the terms and conditions set forth in this Term Sheet are not legally binding on the Parties, save and except to the clauses pertaining to expenses, confidentiality, exclusivity, amendment, governing law and

	arbitration set out in this Term Sheet, which shall be legally binding on the Parties.

Accepted for and on behalf of

By: ________________________________

Name & Title:

Date:

8.3. SPIRIT Rating System

The following information is based on the interview of Lisa Sherk, where she gave an in-depth understanding of the BO social goals.

The SPIRIT rating system is a proprietary scorecard developed by BO in order to assess whether institutions have development goals and whether their practices allow them to achieve these goals. The idea behind SPIRIT is to have a standardised framework that is flexible enough to be used with different types of strategies. The framework incorporates the Universal Standards of Social Performance Management, created by the Social Performance Task Force.

1. Define and monitor social goals of the institution. This looks at the mission statement and overall strategy. It allows the fund manager to judge different institutions on an equal plate, without a value judgement on whether they have a poverty reduction focus or a job creation focus. The main point is whether they have articulated their strategy, whether the strategy has a development angle and if it is clearly identified through who their target clientele is. Again, the idea is to have a framework that can be used for a variety of different institutions. These goals must be achievable and are measurable. The goals and objectives need to have indicators that are realistic.

2. Ensure Board management and employee commitment to social goals. The second part is on how the investee is planning to reach the goals and the processes currently in place. This includes various elements such as Board composition, educational experience background and the goals. The investor should meet and discuss them in order to clearly articulate monitoring and assessment on the individuals and how they are performing to achieve these goals. There is also the focus on employees; how they are trained and educated with regards to the institutions social mission, the incentives alignment with the goals and the monitoring process.

3. Design products, services, models and channels that meet clients' needs and preferences. Does the investee provide services that allow it to meet the objectives? Are they providing them in a way that the products can actually access them? The investor should see the menu of products that they actually have. This includes both financial and non-financial products (insurance, savings, etc). In the design of products, are they taking client's feedback? The Investor would also look at client retention rates.

4. Treat clients responsibly. This section is around client protection and consumer protection issues that are well articulated in Microfinance in the SMART campaign. This includes criteria on SMART campaign endorsement; however endorsement has a relatively low weighting. Beyond merely endorsing, what is the proof that they are following the principles in daily operations in the loan criteria? An interesting part is that a lot of client protection is covered in BOSCO[8] which is more from the risk perspective. Client over indebtness is an issue for both the client and the financial institution. The strength of the institution's underwriting is the most important from both the social and financial performance side. This has the highest weighting in both SPIRIT and BOSCO scorecards.

5. Treat employees responsibly. This looks more at treatment of employees on a personal level. Are they compensated properly? Are their rights articulated properly? How does this show up in the employee turnover? There can be reasons for turnover that are unlinked to the employer, such as more choice within the market place. The Investor also looks at employee satisfaction through employee surveys and the reasons why people leave.

[8] Financial score card

6. Balance financial and social performance. This is a more controversial area than some of the others. The other areas are pretty straight forward, whether the business is social or not. There will be different opinions on the trade-offs. What is looked at here is responsible pricing (higher than competition, reducing costs, etc) and if there is a balance. The financial institution has to charge a certain amount to be sustainable in the long run but keeping in mind the customers. Is the investee growing just for the sake of growth? Or is growth occurring in a sustainable manner? What is the compensation of executives, and the difference between senior management and field employees? This is especially important for the product pricings.

7. Promote environmental protection. This is not part of the universal standards, but generally speaking, this is something that is being added by others in the market. In the beginning, the idea was not included as MFIs do not have a big environmental Impact. There are however elements that have increasingly been seen as making environmental issues relevant such as green loans (loan products specifically designed for clients to purchase environmentally friendly products such as biodigestors, solar panels, insolation for a home, etc.). Often, they will have a lower interest rate or be linked to an NGO/business in the market that produces such products.

8.4. Study presentation to fund managers

Bound to impact: a best practices guide to term sheets in African impact investing deals

Interview and documentation review scheduling

[insert fund manager's name]

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Thesis presentation and scope

- In order to complete the Masters of Commerce in Development Finance at the Graduate School of Business (UCT, South Africa), all students are required to submit a 30'000 word academic research paper on the subject of their choice.
- Nicholas Pepper, in collaboration with the Bertha Center for Social innovation, is focusing his thesis on the impact investing industry.
- The purpose of the paper is to highlight key innovations in deal structuring and term sheet drafting in order to compile a best practices guide.
- The end users are academia, fund managers, investors and organizations raising impact capital.
- To date, there is a void in the literature on this particular subject, and the researcher believes it has the potential to significantly contribute to the industry's knowledge.

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Scope, research and data collection

- The objective of the study is to include five (5) independent fund managers who market themselves as impact investors, of which at least one (1) specializes in private equity and at least one (1) specializes in private debt. In addition, the fund managers must have a footprint in sub-Saharan Africa.
- The data collection process, identically replicated between each fund manager, is as following:
  1. Initial interview with fund representative (overview of fund, governance, deal structuring and term sheets)
  2. Interview with employee specialized in social impact (In-depth understanding of goals, monitoring, reporting, enforcing)
  3. Documentation review (3-4 term sheets of selected deals highlighting innovation, tailoring, breach of covenants clauses, etc.)
  4. Interview with an investment professional who has been involved in the studied term sheets, semi-structured interview mainly on anecdotes and specific questions to relating to studied documents.

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Schedule and selected documentation (please fill in the yellow areas)

Date	

Stage	Type	Time required (hours)	Respondent	Interview mean (Live, Skype, Call)	Email, Skype and/or Number	Time slot
1	Interview	0.5 - 1		Live		HH:MM – HH:MM
2	Interview	1				HH:MM – HH:MM
3	Documentation review	4-5				HH:MM – HH:MM
4	Interview	1-2				HH:MM – HH:MM

Doc #	Company	Industry	Financial instrument	Geography	Exited ? Y/N
1					
2					
3					
4					

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FULL COLOUR THINKING

Confidentiality

- The researcher understands that the study covers sensitive and confidential information. In addition to the individual funds requirements (NDA), the researcher can offer the following
  – Final review of research before submission
  – Opportunity to require an interview written transcript

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